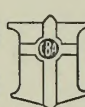


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BOSTON UNIVERSITY
College of Business Administration

THESIS

Functions of Internal Auditing in Business Management

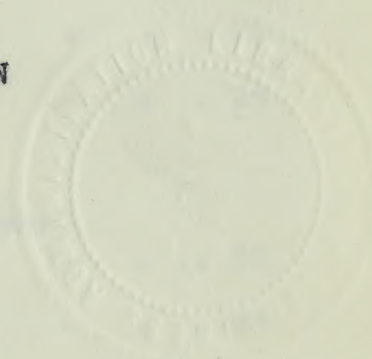
by

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(B. S. University of Illinois 1948)

Submitted in Partial Fulfillment of
the Requirements For the Degree of

MASTER OF BUSINESS ADMINISTRATION

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CHAPTER I

INTRODUCTION

Business, as we know it today, is the result of a long series of evolutionary phases. While the principle of having some commodity to sell to our fellow man has remained the same, the methods and the quantities involved have changed greatly. These changes are the most notable in three of the fundamental elements of business; production, selling, and finance.

During the early days of this country, production was centered in the home. Almost all families were self-sufficient to a very large degree. The items purchased either were brought from abroad or were obtained from a neighbor, who had developed a skill in producing one particular article. As the home producer became especially proficient in producing one item, there was a tendency towards concentration. If the item met with a demand, the home producer would most likely enlarge his scale of production. He would hire additional workers, perhaps a younger relative or a neighbor's son. As time went on and the demand continued, more workers would be hired. However, the management of the enterprise would remain in the hands of the original craftsman, who started the business. The tie between worker and management was very close, in fact it was one of fellow workers. Since management was also a part of production and

was able to maintain an on-the-spot observation of every phase of the business, the control of operations was immediate. The selling function was very direct and simple because most all production was based on the needs of the immediate community only. The management of the business furnished the money for the needed tools and supplies so that there was no need of accounting to any outside parties. It was in this phase of the business development that the organization structure was the simplest and management control the most direct.

The continued growth of the country and the increase in demand for goods transferred production from the home to the small factory with a force of fifty or a hundred men. Even at this stage of the growth of the business; managerial control over the functions of buying, producing, selling and the keeping of records was so concentrated that one man could still maintain a constant control over all of the elements of management.

During the latter part of the nineteenth century, business began to expand along the lines we know today. It was a period of rapid expansion with little or no government regulations. The control of the large corporations was maintained by men of great daring and ability; the Rockafellers, the Goulds, the Harrimans and the other promoters of that era. The financial promoters made large profits through the various consolidations of companies rather than through concentrating on efficient operations. This was an era of strong

personalities who made their influence felt throughout the organization. The men in the lower echelon of management had grown up with the business, and, therefore, they were aided in their control of operations by an intimate knowledge of every phase of operations.

The twentieth century brought into the world the billion dollar corporations whose employees number in the tens of thousands. It also brought along a radical change in the conditions under which management must operate. The close contacts with the various units of the organization which top management had previously been able to maintain were no longer possible. The increased number of employees had caused delegation and redelegation of authority to be the pattern of organization. Geographically, the assets and operations of the enterprise have come to be spread over wide areas - both nationally and internationally.

The great growth of the corporate enterprise has caused managerial control to become more impersonal, and management has been forced to look for new controls in order to secure efficient operations. One of these controls, upon which management places great reliance, is the accounting data.

As the period of rapid corporate growth came to an end, management turned its attention to scientific management and general efficiency in all phases of operations. As a result, careful appraisal and analysis of internal operations

are constantly being performed. This analysis is normally best made in both a physical and a financial sense, through the analysis of the accounting data compiled as the results of operations.

In writing of management's reliance upon accounting data, Jarchow says:

The degree of success of a business is almost wholly due to the quality of its management. In order to successfully direct a business, management must have first-hand knowledge of the results of operations. This knowledge of the business is based largely on the constant flow of reports from the accounting sections of the various operations. (1)

Internal auditing, like accounting, has developed in answer to certain needs created by the growth of the corporate form of business. The increase in size of the average business organization has led to greater reliance on accounting data in order to control the operations of the various units of this organization. This greater reliance on accounting data has in turn resulted in a need for verification of the accuracy of the data. The internal auditing functions has developed to give management a tool for the verification, analysis and review which is so vitally needed.

Another change that has caused management to seek

- (1). Christian E. Jarchow, "Controllershship and the Internal Auditor", Internal Auditing Looks Ahead, (New York: The Institute of Internal Auditors, 1949), p. 29.

new methods of control is the increased regulations that have been placed on their actions. Never before in the history of the United States has management been hampered by federal and state legislation that place requirements on management in the way of reports, registrations and taxes. This increased regulation of private enterprise has placed an increased responsibility on management.

The requirement for accurate data, and the need for constant appraisal of the various operating processes and procedures to determine if all of the various legislative requirements are being met has created a need for an appraisal agency within the organization.

The great concentration of wealth in the large corporations, the large number of workers and their families who depend on selling their services to the corporation for their livelihood, and the large number of absentee owners have created a responsibility which top-management owes to a large part of the population.

Top-management can no longer excuse errors of judgment by passing the blame down the managerial ladder. The spotlight of publicity has been turned on management by the press, in stockholder meetings and by the many government agencies. More stockholders are demanding the details of operations of the enterprise in which they have invested their savings. The Security and Exchange Commission's regulations have forced management to vouch for significant financial facts concerning the financial data of their company.

Management is thus placed in a position where it must have data which has been verified as to its accuracy.

Hald writes of this new responsibility of management and says:

To justify the confidence of investors and safeguard its harmony with labor, management must exercise continual and unbiased supervision and review of all company activities. Obviously the task is too great for top management without employing competent and organized assistance. (1)

At no time in the history or development of American business has the responsibility of top management been greater than it is today. It is the function of top management to determine the common ends toward which effort shall be directed and to maintain coordination between specialized functions or departments. The coordination of activities calls for an appraisal of the various units to determine if they are following the procedures and methods laid down by top management. Moreover, a review of the operations must be made to determine whether the results achieved by the various operations are up to the standards set by top management. For these reasons internal auditing has been developed as a means of aiding management in its problem of coordination.

However, even with the recognition of the new con-

- (1). Arthur E. Hald, "The Functions of the Internal Auditor", Internal Auditing Philosophy and Practice, (Stamford, Connecticut: Brock and Wallston, 1944), p. 4.

trol problem of modern management, there has not always been a recognition that management can obtain a tool that will aid by adding an extra pair of "eyes and ears" to management controls. This tool is internal auditing. Even among those that recognize that internal auditing can be an aid to management, there remains a great lack of understanding of the scope of internal auditing and the possibilities of its function as a tool of management.

The lack of recognition of the full possibilities of internal auditing is in part due to the comparative newness of the function. Of this newness, Brink says:

Why is it that American industrial corporations have not recognized to a greater extent the benefits to be obtained through internal auditing, and why have the programs by which these benefits might be obtained not been more effectively developed? The answers to these questions involve many factors which overlap and are inter-related. There are, on the one hand, general factors such as newness of the subject and the lack of explanatory material which has been developed for those persons engaged with the internal auditing problem, while on the other hand, there are the causes arising out of the deficiencies of the various participating groups. (1)

Even on the part of the accounting and auditing personnel, there is often a failure to understand the real nature of internal auditing and its opportunities of serving management.

(1) Victor Z. Brink, Internal Auditing, (New York: The Ronald Press Company, 1941), p. 492.

Purpose

The major purpose of this study is to review the field of internal auditing and to present the current thought as to the services which top management should expect and obtain from the internal auditing group. It is the further purpose to point out how, as a tool of management, internal auditing has progressed beyond the arithmetical verification of accounts, records and financial statements. Further, it is also the purpose to show the growth of internal auditing into a complete intra-company financial and operational review, embracing in addition to accounting accuracy, perfection of the system of internal control and reliable assurance of adherence to standards of performance and to established policies and procedures.

Terminology

Since internal auditing has experienced its greatest growth over the past fifteen years, there still exists a certain confusion of terms used in the discussion of the subject. In order to establish a firm footing, the terminology of certain related terms used in this paper will be discussed.

In this paper, the term "internal auditing group" or "internal auditing department" is used to indicate the activity of auditing carried on by employees within the company whose specific job is the review and appraisal of the company's operations.

The definition of the term "internal auditing" has been given as follows:

Internal auditing is the independent appraisal activity within an organization for the review of the accounting, financial and other operations as a basis for the protective and constructive service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters, but it may also properly deal with the matters of an operating nature. (1)

It is felt that the above definition fully covers the term as used in this paper. The definition gives a complete coverage to the modern concept of the function of internal auditing.

The term "internal auditing" should not be confused with the term "internal check".

The Special Committee on Terminology of the American Institute of Accountants gives the following definition for the term "internal check":

Internal Check: A system under which the accounting methods and details of an establishment are so laid out that the accounts and procedures are not under the absolute and independent control of any one person - that, on the contrary, the work of one employee is

(1) Charles J. Fue, "Responsibilities of the Internal Auditor", The Internal Auditor, (September, 1947), p. 20.

complimentary to that of another - and that a continuous audit of the business is made by employees. (1)

It should be kept in mind that while the internal auditing group may recommend improvements in the system of internal check and may appraise or review the operations of the system, the two are distinct and different elements in modern business controls.

The term "outside auditor" is used to indicate an auditor or a group of auditors from a public accounting firm. It is the responsibility of the outside auditor to review the company's books and to issue an independent certificate as to the accuracy of the financial statements. While the outside auditors' field of operation covers more than the annual audit, the annual audit will be the only operation treated in this paper since it is the most important function performed by them for the average corporate enterprise.

The term "management" is used to indicate the upper level of supervision. This group consists of executives who are concerned with the business as a whole rather than the divisional management, who are directly responsible for the various departments or divisions of the company.

The term "control" has two aspects in this paper, managerial control and internal control.

- (1) Report of the Special Committee on Terminology of the American Institute of Accountants, Accounting Terminology, (New York: D. Appleton Century Co., Inc. 1931), p. 37.

The following description of managerial control gives the elements of the term as used in this paper:

Each plan of control embraces the following elements: an objective establishing what it is desired to accomplish; procedure specifying how, when and by whom the plan is to be executed; criteria as to what constitutes good performance; and appraisal as to how well it was done. (1)

The internal auditing is a part of managerial control in that it is a principal means for appraising and evaluating the results of the performance.

The term "internal control" as used in this paper may be defined as follows:

The scientific distribution of duties and responsibilities which is made by an organization in order to establish a system of checks and balances so designed that the activity of one officer or employee independently performing his own prescribed work will check automatically, continuously and with little or no duplication, the work of another or others. (2)

- (1). Paul E. Holden, Lounsbury S. Fish and Herbert L. Smith, Top-Management Organization And Control, (Stanford, California: Stanford University Press, 1948), p. 9.
- (2). John B. Thurston, Basic Internal Auditing Principles And Techniques, (Scranton, Pennsylvania: International Textbook Company, 1949) p. 8.

Objectives

The general objectives of this paper are as follows:

1. A survey of the present day concepts of internal auditing.
2. The considerations of how these concepts can be applied by management as a tool of control.

The first of these objectives concerns the nature of internal auditing and its various functions. It involves research into the gradual evolution of internal auditing functions from one of mere arithmetical checking to the present day status of an independent investigating and appraising arm of top management.

The second objective concerns the specific services and their relations to the appraisal element of managerial control. In considering the second objective, the ideal operation of internal auditing will be presented.

In regards to the second objective, this study will show how the extension of the full functions of internal auditing can mean the difference between a highly efficient staff organization that can serve as an extra pair of "eyes and ears" for management and a plodding group of arithmetical verifiers.

Scope

This paper is written from the managerial rather than from the accountants' point of view. The services and aids which management can gain from internal auditing will be emphasized. The details and the mechanics of the various types of audits will not come into the scope of this paper.

While internal auditing has its roots in accounting, the present day tendency is to make internal auditing an extension of management. The function of review and appraisal of the various operations has given internal auditing a wider scope of operations. It is no longer bound by purely statistical and financial considerations, but has assumed the managerial viewpoint.

The scope of this study is not confined by the operations of any single organization. Rather, it covers all of the major functions that should be performed by an alert, well-organized and well-qualified internal auditing staff.

CHAPTER II

INTERNAL AUDITING

Internal Auditing Defined

In Chapter I, a common definition of internal auditing was given. While it defines the term in general, there are many other elements involved which are not fully brought out in the definition. Thurston, in his recent book, gives a more detailed and comprehensive definition of internal auditing as follows:-

Internal auditing is the determination by an organization's own employees (1) that its records and reports reflect actual operations and results fairly, accurately and promptly; (2) that established controls are not only adequate for the full protection of the company, its owners, its management and its employees, but also that these are effectively maintained and (3) that each department or other unit is carrying out the plans, policies and procedures for which it is responsible. (1).

The above definition shows that only a part of the duties of the internal auditing group is directly connected with auditing as the term is understood by the majority of the people.

To some extent, internal auditing suffers by its name. Auditing is usually thought of as the science of the

- (1). J. B. Thurston, Basic Internal Auditing Principles And Techniques, (Scranton, Pennsylvania: International Text Book Company, 1949), p. 1.

Examination of accounts and the verification of entries to these accounts by means of approved procedures. The purpose of the examination, as the usual connotation of auditing holds, is to enable the auditors to form sound opinions regarding the accounts and financial statements of the company being audited.

Modern internal auditing is a much broader field. The routine checking and verification of accounts is only one phase of the operation. With the introduction of machine accounting, clerical errors have been greatly reduced; thus, part of the need for checking has been eliminated. However, it should be emphasized that continued need exists for constant attention to the adequacy of the methods of internal control and to the maintenance of established standards of accounting and operations.

In writing of the evolution of internal auditing, Thurston says:

Internal auditing is no longer the narrow checking operation it was in the past. Today internal auditing is recognized as the examination of the functioning of an organization's own officers or employees for the purpose of determining whether or not established methods, policies, procedures, and practices are being followed and whether they are being followed both effectively and efficiently. (1)

- (1). John B. Thurston, "Modern Internal Auditing And Its Relationship to Industrial Engineering", The Internal Auditor, (March, 1948), pp. 28-29.

However, since the term "internal auditing" has been applied to the activity of internal appraisal or review from its beginning, it is only natural that the name has stayed with the function, even though the activity has progressed beyond the narrow confines of the financial audit. Internal auditing does not ignore the underlying responsibilities of the accounting audit, but it uses the basic processes of the accounting audit only as a starting point for review by which it can make greater contributions to management through constructive analysis and appraisal of operations.

In speaking of the constructive concept of the internal auditing function, Cunningham says:

While the auditor is charged with a rather wide and a varied type of policing service including the detection of fraud and error, it is the constructive service which he renders which enhances the value of his work. The internal auditor who renders no more than "protective" services has not yet attained professional status; he is merely performing a clerical routine - a policing service. (1)

As a bases for the discussion of the work of the internal auditing group, the organizational level of the department and the type of internal auditing performed must first be discussed. This review or discussion is necessary

- (1). E.H.Cunningham, "Internal Auditing - A tool of Management", The Internal Auditor, (Decemter, 1948), p. 18.

because the scope of operations, the matters with which the internal auditor will concern himself, the techniques he will concern himself, the techniques he will use to achieve his objective, his independence of action, the method of style of reporting, and many other factors will vary with the different types of internal auditing.

Organizational Types of Internal Auditing

The failure to recognize the various organizational types of internal auditing is perhaps the principal reason for some of the misunderstandings that frequently arise when the subject of internal auditing is being discussed. Internal auditing may be grouped into four major organization types. These are: (1) Proprietorship Internal Auditing; (2) Management Internal Auditing; (3) Staff Internal Auditing; and (4) Departmental Internal Auditing.

When the internal auditing group is completely independent of all other management personnel and is appointed by and is responsible only to the owner of a sole proprietorship, or the partners of a partnership, or the directors of a corporation; the internal auditing function is termed Proprietorship Internal Auditing. In this type of internal auditing, the internal auditing group is directly concerned with all phases of operation and management. As a result, the activities of this type of auditing group are the widest in scope of any of the four types.

The term "management internal auditing" refers to the functioning of an internal auditing group appointed by the president, the executive vice-president, or other management authority who hold a similar level of responsibility. The internal auditing group is independent of all other personnel below this strata of management. Its duties and scope are much the same as the proprietorship type of internal auditing. However, it is a representative and an appraiser for top administrative management rather than the proprietorship or trustee function of top management.

The staff type of internal auditing is the type most frequently encountered in the large corporate organizations. The head of the internal auditing staff is usually appointed by the Vice-President in Charge of Finance, The Treasurer, The Controller, or by some other staff officer holding a relative rank in the organization. The internal auditing group has no authority to function outside of the area of responsibility of the staff member to whom it reports. In many organizations, the Financial Vice-President or the Controller has a company-wide responsibility or authority which usually stems directly from the board. As a result, the scope of the internal auditors' work is also company-wide. It covers all of the activities over which the staff member, to whom the internal auditor reports, has authority.

When the function of internal auditing is confined

to the limits of a department, the function is termed departmental internal auditing. The head of the internal auditing group is appointed by and reports to the head of the department in which he serves. Care should be taken to differentiate between those departmental activities which are truly of an auditing nature and those activities which are merely a part of the internal check.

Functional Types of Auditing

The second consideration that should be made in discussing internal auditing, is to define the various functional types of auditing. As in the various organizational levels of internal auditing, the scope, objectives, techniques and style of reporting will vary with each type of auditing work. The functional types may be broken down into three main groupings as follows: (1) continuous audits, (2) feature audits, and (3) periodic audits.

The continuous type of audit may be broken down into two classifications; the pre-audit and the post-audit. These two classifications vary only in respect to the time the internal auditing group performs the work. The continuous audit is used where it is desired to have all transactions verified. The auditing is performed largely by departmental internal auditors; such as Disbursements Auditors, Accounts Payable Auditors and Payroll Auditors. This type of audit is usually found in the cases of geographically diversified operations which are too small to permit

the full operations of a good system of internal control. Continuous audits are usually performed in such a restricted field that they should be considered a minor function, although an important one in certain operations, of the entire picture of internal auditing as it is used by management.

Feature auditing consists of examining one phase of operations at a time. Some of the more common functions of this type of audit are audit of cash receipts, payroll audits, accounts receivable, circularization and observing and checking of physical inventory counts. The frequency of feature audits will depend on type of operation under review and the requirements of the various departments concerned.

The periodic audit covers a review of all the operations of a plant or unit being audited. Periodic audits are generally employed when a company's operating and accounting activities are diversified and are located at more than one place. In large corporate organizations where resident internal auditors as well as traveling internal auditors are on the auditing staff, the resident auditors generally perform the feature audits while the traveling auditors make the periodic examinations or audits.

The organizational structure and the objectives to be accomplished determine which type of audit will be used in a specific case. All of the above mentioned audits may be utilized to make up the entire program of review performed by the internal auditing department.

History

The function of internal auditing differed materially in the past between companies as it continues to differ today. As a result of this difference, a clear pattern is not revealed in the evolution of internal auditing. However, certain definite trends in the concepts and responsibilities of internal auditing can be seen.

In the days prior to machine accounting and systems of internal control which are a basic part of accounting today, much of the so-called internal auditing was directed at assuring the greatest possible accuracy of records and reports and the checking of postings, extensions and footings. This type of auditing was strictly non-productive. It was a duplication of effort and was considered as a wasteful but a necessary evil. As the result of concentrating on this type of auditing, internal auditing was looked upon as strictly a verifying procedure with little or nothing constructive to offer to management.

In the past, internal auditing was often established as an appraisal function after a fraud has been committed. Since auditing was looked upon only as a means of preventing or detecting fraud, it was only natural that the basic function of the internal auditing group was that of assuring protection of the physical assets; and all other considerations were directed towards this end.

While management did not always fully recognize the

full possibilities of internal auditing as a control function in the past, some of the more far-thinking auditors saw that internal auditing had the fundamental requirements needed to aid management in its control of business.

Thurston, in his recent book Basic Internal Auditing Principles and Techniques, mentions that Monroe Kirkman stated as far back as 1877 that the vigorous discharge of the duties of an internal auditor is not a matter of judgment, but that the internal auditor is expected at all times to make use of all the possibilities of his position for the protection of the interest of the company he represents.

In 1912 a book written by Reginald Arthur Davenport recognized the future expansion of internal auditing. Davenport pointed out that while this profession was not a new one, it was only on the threshold of its ultimate usefulness. He explained that the internal auditor's work should not be confined to a mere mechanical audit of the accounts, but it was the internal auditor's duty to observe and report upon all phases of the welfare of the company he represents. Davenport contended that the field of internal auditing was, and is, so broad that not even the most progressive members of the profession had a real conception of its possibilities.

Although there were a few far-sighted men in the field who were able to foresee the possibilities for active participation as an aid to management, the majority of management, and even the auditors themselves, regarded the

internal auditing function as being restricted within the narrow confines of arithmetical verification of accounting data.

The interest in internal auditing arose largely since the turn of the century. During this period, the concepts of the duties of the internal auditor, his objectives, and the scope of his work have broadened materially. The new responsibility and functions of internal auditing are being used by management as a means of furthering the efficiency of the modern corporate organization.

Reasons for Recognition and Growth

Since early business organizations were comparatively small, their owners or the managerial representatives of the owners were able to personally exercise direct controls over operations. As a result, little more than the policing of the accounting function was needed to assure proper control over the various phases of operations. With the expansion of the corporate organization, management was no longer in a position to exercise direct control over all of the far flung operations.

In the preface of a recent book on top management requirements, J. Hugh Jackson makes the following comments in regards to the growth of the business organization and the necessity for the additional delegation of authority:

Chief executives themselves are generally aware of the many problems of co-ordination and control which constantly beset them. However, experience has shown that many times expansion in management organizations are the results of immediate necessity and accordingly the organization planning goes no further than to solve the problem currently in hand. The allocation of important functions on such a basis can only result, sooner or later, in a management organization which, although it may be moderately successful in attaining results, will speedily become so cumbersome and lethargic as to lose most of its effectiveness. (1)

Thus, in the larger corporations, there has arisen a need for a logical, well-planned system for delegating authority. The corporate structure may be divided into a number of sub-groups based on the functioning of the company or into a number of divisions if there are a number of diversified operations. In either type of structure, the managers of the various divisions are given a broad delegation of responsibility and authority with top management serving as a staff to supervise, advise and assist the various divisional units. However, the responsibility of top-management for staff supervision of the various subsidiary units cannot be properly exercised without definite, accurate and complete knowledge of the functioning of these units.

- (1). P. E. Holden Lounsbury, S. Fish, and Hubert L. Smith, Top-Management Organization And Control, (Stanford, California: Stanford University Press, 1948), p. VII.

Internal auditing has grown to fill the need for an appraisal organization which will assure management that the operating statements, which are one of the principal gauges of results, have been prepared according to the prescribed rules and procedures.

Top management is definitely operating by remote control. This very remoteness from the actual field of operations is why the internal auditing function has assumed a new position in management with a vastly wider field of operations. The remoteness calls for an extension of the "eyes and ears" of management. In speaking of the separation of management from the operating units, Cunningham says:

It matters not how able his staff may be, nor how well the integrated pattern of management may be formed, defects and deterioration are sure to develop unless vigilant surveys and evaluations are maintained. (1)

The recognition of the need for internal auditing is often made only after serious difficulties arise in the organization. Mr. Reitzel, Controller of Sun Oil Company, was one of the leaders in recognizing the need. The Sun Oil Company inaugurated internal auditing in 1923. In writing of the recognition of the need for an appraisal and a reviewing agency, Reitzel stated:

- (1). E. H. Cunningham, "Internal Auditing - A Tool Of Management", The Internal Auditor, (December, 1948), p. 17.

It was apparent that there was something missing in the organization of these large corporations. Eventually I came to the conclusion that it was lack of modern internal auditing, lack of men who could float around and see that things were being done correctly, men who could co-ordinate one man with another and one job with another. (1)

Management had long recognized that inspection of production was necessary in order to obtain standard quality. However, the need for inspection of functions not related directly to production was not always seen.

Cunningham very aptly sums up the situation as follows:

Recognizing that inspection of management functions, clerical routines and operating activities is as essential as inspection on the production line, management utilizes internal auditing for the purpose of securing the benefits of an independent and objective review and appraisal of its many responsibilities. (2)

Management has developed systems of internal control as an automatic device for the assurance that company policies and procedures will be effectively carried out and for preventing and detecting accounting errors and fraudulent use of company assets. The number of controls making up an entire system of internal control will vary with the

1. F. S. Reitzel, "Modern Internal Auditing", Internal Auditing A New Management Technique, (Stamford, Connecticut: Brock and Wallston, 1943), p. 61.
2. E.H. Cunningham, "Internal Auditing - A Tool of Management", The Internal Auditor, (December, 1948), p. 17.

size and the requirements of the enterprise. Some of the most common types of controls utilized by management are: budgetary control, cost control, production control, internal check, internal auditing and many others of similar nature.

While internal auditing is listed along with other managerial controls, it is of a different character in that it supplements rather than complements the other forms of control.

In writing of the internal auditing groups' position in the scheme of internal control, Thurston states:

In any large business, internal auditing is the keystone of internal control. In other words, no system of internal control can be considered adequate or complete unless it includes internal auditing. Even if a perfect system of internal control existed, with each transaction broken down into steps that counterchecked one another in the hands of different employees, internal auditing still would be necessary. (1)

The necessity for internal auditing arises from the constant need for appraisal to determine whether each step of the control is functioning as planned and to recognize needs for changes resulting from changing conditions.

- (1). J. B. Thurston, Basic Internal Auditing Practices and Techniques (Scranton, Pennsylvania: International Textbook Co., 1949) p. 17.

Thurston compares this need to that of an automatic machine needing an inspector, when he says.

The perfect system of internal control may be compared to a modern power plant that is designed to be completely automatic in operations. Such a plant would not be left without some supervision. A trained engineer would be assigned to check it and maintain it. The internal auditor is the "trained engineer" assigned to check and maintain the system of internal control. (1)

It has been only during the past few years that internal auditing has come to be recognized as an arm of top management. The recognition has come about partly through the awakening of management to the fact that a definite need existed. However, the internal auditing function would not have been called upon unless it was able to adopt itself to the changing conditions. Internal auditing could not have achieved its present standing as an arm of management unless the results produced justified the endeavor.

While the present day concept of internal auditing has its basis in the auditing of accounting records and financial statements, it has broadened its scope of activities into a wider area of managerial responsibilities.

(1). "ibid", p. 17.

Thurston presents the extent of expansion as follows:

Today those who understand it, (internal auditing), recognize it as a technique for providing top management with many important facts it would not otherwise have; for insuring adherence to budgetary standards; for securing observance of company policies; for establishing adherence to laws, regulations and contract terms by officers and down-the-line-executives; for calling attention to the inadequacy of many types of physical property in their use; for weeding out incompetent personnel and for highlighting talent; and for following up the work of the industrial engineer by seeing that new methods, procedures and practices, once installed, are maintained. (1)

- (1). J. B. Thurston, Basic Internal Auditing Practices and Techniques, (Scranton, Pennsylvania: International Textbook Co., 1949) pp. 28-29.

CHAPTER III

MANAGEMENT'S VIEWPOINT DETERMINES EXTENT OF INTERNAL AUDITOR'S ACTIVITIES

One of the prime differences between the internal auditor and the outside auditor is that the internal auditor's primary responsibility is to corporate management, while the outside auditor's primary responsibility is to the stockholders of the corporation. As a result, the outside auditor's primary concern is with the soundness of the financial statements upon which he expresses his opinion. The internal auditor's concern is primarily with constructive analyses and appraisals which top management needs in controlling the various operations. As a result, the extent of the internal auditor's activities is bound by the limits set up by management.

Restrictions on Activities

The activities are sometimes limited to appraisal and review of accounting and financial data. Such limitations placed on the activities of the internal auditing group are unfortunate since they deprive other departments and units of the organization of the means of securing independent analysis and appraisal of operations, or else they compel them to set up individual staffs of investigators to perform the appraisal and review function for which the background and training of the internal auditor is best

suites. The use of multiple departmental staffs of investigators is obviously uneconomic and inefficient.

In other cases, far-sighted executives have taken advantage of the internal auditor's training and qualifications by giving him a wide latitude in action and expression. As a result of this wide variation, it is difficult to set definite limits in describing the internal auditing group's responsibility.

Since the reporting responsibility of most internal auditing groups is to top management, the effectiveness of the internal auditing function is limited by management's policy making and policy execution.

Payte states that management has definite responsibilities in setting the policies and following them through so that it can gain the greatest benefit from internal auditing. In this connection he says:

Management must first define in general terms the objectives of the internal auditor and, secondly, through active support, must impress on the operating personnel the need for their co-operation with the internal auditor to attain that objective. Lacking these fundamental supports, the internal auditor can operate only with the sufferance of those audited. (1)

- (1). Henry L. Payte, "The Effect of Management Policies on the Activities of the Internal Auditor", Internal Auditing Philosophy and Practice, (Stamford, Connecticut: Brock and Wallston, 1944), p. 66.

It can be seen that if management wants to obtain the full benefits of an independent appraisal and review, the extent to which they are able to accomplish this end is determined by the policies which management adopts. If maximum results are to be obtained, policies must be broad, well thought out and coordinated.

In determining the policies that will govern the functioning of the internal auditing group, management should be guided by the fundamental considerations used in the determination of all policies. Payte states the considerations that should be made by management as follows:-

The first decision to be made concerns the area of audit activities. There are gradations in internal auditing. Consideration must be given to questions of whether the audit should be limited, let us say, to a check of accounting records; or to be all-inclusive, covering all phases of the business where auditing can be effectively applied; or somewhere in between. (1)

The above question cannot be answered until management has a clear understanding of what internal auditing can accomplish and some idea of what the company needs in the way of a review agency.

- (1). Henry L. Payte, "The Effect of Management Policies on the Activities of the Internal Auditor", Internal Auditing Philosophy and Practice, (Stamford, Connecticut: Brock and Wallston, 1944), p. 66.

Reporting Responsibility

Since independence is basic to the effectiveness of the internal auditing program, the chief auditor should be made responsible to an officer of sufficient rank in the organization as will assure adequate consideration or action on the findings and recommendations of the internal auditing group.

The position of the officer to whom the internal auditor reports determines to a large degree the place of the internal auditing group in the corporate structure. In order to be fully effective, the internal auditor must be free of departmental obligations, influence, or bias, and be able to take a broad objective viewpoint based solely upon the best interest of the company as a whole. He must be in a position to investigate and call attention to unsatisfactory conditions in any division or department and to initiate recommendations toward their correction. This independence of view point and action is rendered difficult if the internal auditor reports to the head of one of the divisions or departments concerned because the interests of the internal auditor may conflict with those of his superior.

It is generally agreed that the internal auditor should report to someone higher than the departmental level. It is further agreed that to be of the widest possible service, consideration should be given to the advisability of including the internal auditor in the general company executive group. However, current writing on the subject pre-

sents two distinct theories as to whom the internal auditor should owe his reporting responsibility.

The first school of thought stresses the need for independence of action if the internal auditing group is to function satisfactorily. This group believes that the board of directors should have a determining voice in the selection of the internal auditors and that the chief auditor should report directly to the board. It is believed that internal auditing is one of the principal means whereby a board of directors can discharge their trusteeship function.

In support of the point of view that the chief auditor should report directly to the board of directors, Thurston states:

The board of directors, acting as a trustee, represents the owners of the business. It is the board's duty to safeguard and further the stockholders' interests, determine basic policies and the general course of the business, appraise the adequacy of over-all results, and, in general protect and make the most effective use of the company's assets. It is for this reason, that, in many important corporations the internal auditor reports directly to the board of directors either through the auditing or the chairman of the board, or functionally to the board through the president. (1)

- (1). John B. Thurston, Basic Internal Auditing Principles and Techniques, (Scranton, Pennsylvania: International Textbook Co., 1949), p. 29.

Mr. Warthen supports the theory that the chief auditor should report to the board of directors by making the following observations based on the services rendered by the internal auditing group:

To accomplish all of this, the auditor must be placed in an independent position. He must not be told what to audit or what not to audit by a comptroller, treasurer, or anyone responsible for the keeping of the records or the handling of funds. He must be free to make an unbiased check on all transactions covering income and disbursements and to safeguard all assets. He must be free to criticize company policies and report any mismanagement without fear of reprisals. In this position he would also rank with top-management. He should, therefore, report to the Board of Directors, or to a top executive who will furnish the necessary protection should he step on any toes in the performance of his duties. (1)

The viewpoint expressed above by the two writers considers the internal auditing group as serving the trusteeship zone of management only.

The second viewpoint, that the internal auditor should report to the administrative or general management zone of the organization, holds that internal auditing has found its greatest usefulness in the service of the latter group. There are several arguments put out favoring the theory that the greatest utilization of the internal auditing function is in the zone of administrative management

- (1). Harry H. Warthen, "An Auditors Relations With The Stockholders, The Directors, And The Management", Internal Auditing Philosophy And Practice, (Stamford, Connecticut: Brock & Walliston, 1944), p. 76.

rather than the trusteeship zone. It is felt that the delegations of authority made by the trusteeship zone has not been as great or as detailed as the delegations made by the administrative zone. Therefore, the need by the trusteeship zone for an appraisal or review agency is not as great as that of the administrative zone.

Moreover, a survey of the adherence to broad basic policies, operations of major financial procedures, and functions of a similar nature is adequately handled by the outside accountant in the course of his annual audit. The report of the outside auditor is directed toward the stockholders and the board of directors who represent the interests of the stockholders.

A basic principal of organization is that the line of responsibility of a staff unit should be with that part of the organization to which the greatest service is rendered. Using as a criteria the services rendered by internal auditing, it would appear that the internal auditor should report to the administrative management who are concerned with over all operations of the company.

The review and appraisal functions of the internal auditor naturally result in the organization of recommendations for the correction of errors or improvement of systems or procedures. Thus, the internal auditing group should

report to the segment of management which is in control of administering the operating function. In speaking of placing the recommendations into effect, Ellis says:

The responsibility for placing them in effect belongs with the administrative positions not with the Directors and so, if the auditor were to report to the Directors and make recommendations directly to them he would be challenging the judgment and authority of the President and sooner or later place the Directors in the position of having to make a choice between his recommendations and those of the President. In such a position the auditor would be of little service to the President or the Directors. (1)

It is felt that since the auditing function reviews the details of operations that the trusteeship function would have no interest in the detailed variations from policies and procedures laid down by administrative management. The second school of thought on the reporting responsibility of the internal auditor believes that since the internal auditor is concerned with the day-to-day appraisal of specific operating data that the auditor should report to someone closer to the scene of operations than the board of directors.

However, within this second school of thought, there is a variation in the thinking as to which

(1). L. L. Ellis, "Organization Responsibilities of the Internal Auditor", The Internal Auditor, (September, 1946), p. 35.

administrative officer the internal auditor should owe his reporting responsibility.

A very sound argument is put forward that the auditor should be independent of the treasurer's department and some even carry the argument to the point where the internal auditor should be completely independent of the controller's department. The basis for this thinking is that if the internal auditor reports to one of the financial officials, the internal auditor would lose a large part of his independence of action because the larger amount of the auditor's time and effort is spent in the survey and appraisal of financial and accounting operations.

In support of this viewpoint, Brink says:

As to which officer of the management the internal auditor should report, the best general answer appears to be the president or to an officer acting directly as an assistant to the president. Certainly the internal auditor should not report to the treasurer or the chief accounting officer because if this were done he would be under a person who is directly in charge of operations which could not then be audited in an independent manner. (1)

There is an alternate solution to the problem based on the theory that since internal auditing is a part

(1). Victor Z. Brink, Managerial Control Through Internal Auditing, (Stamford, Connecticut: Brock and Wallston, 1943) p. 76.

of the over-all picture of internal control, the auditor should report to an authority who has a direct line responsibility for the various controls. Thurston suggests that a position of an assistant president, who would be responsible for all of the managerial control functions, be created. He suggests the title of Vice-President - Management Controls for this position.

The theory that internal auditing as a control function should most logically be responsible to a unit whose major responsibility is that of control, has gained a wide acceptance. It would appear that the internal auditor should report to the Financial Vice-President.

The responsibility of the Financial Vice-President or, if no such office exists, of the Controller includes: (1) the establishment of financial control over all activities, and (2) the protection and preservation of the company assets.

In speaking of the direct link between the responsibilities of the Financial Vice-President or Controller and the internal auditing function, Ellis says:

While these broad responsibilities are functional in that they represent a highly specialized activity of the business and are thus company-wide, because of this, the authority accompanying them is usually received by the Financial Vice-President or Controller directly from the Board of Directors. The appraisal function of the auditor is an essential part of these control mechanisms. The auditor is an indispensable part of the control team and the Financial Vice-President would be greatly handicapped

in carrying out his control responsibility if the auditor were not a part of his organization. (1)

Mr. Ellis further pointed out that the greatest effectiveness of the service of internal auditing can be gained only by having the internal auditor functioning as part of the system of control. In this way, the efforts of the internal auditor can be coordinated with the other activities which make up the control function; thus being able to provide a complete analysis of the administrative effort for the use of administrative management. In this way, the principle of placing a staff organization line of responsibility with that part of the organization to which the greatest service is rendered, is complied with.

Compliance with the second principle of staff organization, which states that the staff organization should be independent of the functions being audited, is where the question arises as to whether by reporting to a financial officer the internal auditing function is being handicapped.

In regards to the loss of independence by reporting to a financial office, Mr. Ellis points out that if the internal auditor was reporting to either the operating, the service, or the administrative branches of the organization, he would have little independence since he would be review-

(1). L. L. Ellis, "Organization Responsibilities of the Internal Auditor", The Internal Auditor, (September, 1946), p. 35.

ing and appraising the effectiveness of the operations of the services and of the administration. He could not carry out his responsibilities independently if he reported to any one of these branches. If the internal auditor reported to the Board of Directors, he would be unable to present his appraisal of administrative action without direct conflict with the president. If he reported to the administrative zone of management, he would immediately lose part of his independence, as he would be appraising the end product of the policies set by the administrative zone.

In summarization of the place that internal auditing should have in the organization in order to gain the greatest freedom and independence of action, Mr. Ellis says:

He is in the greatest position of independence if he is reporting directly to the financial vice-president or a controller who has company-wide responsibility and authority, usually stemming directly from the board. The only phase of his work in which he would not be entirely independent is in the verification of accounting records. This we have seen is a minor part of his responsibilities and is always subject to the further verification by the public accountant. (1)

Surveys that have been made of the various reporting responsibilities of the internal auditor, show that the majority of the heads of the internal auditing groups report to an administrative officer. Tabulated below is the results of 163 inquiries made as to the reporting

- (1). L. L. Ellis, "Organization Responsibilities of the Internal Auditor", The Internal Auditor, (September, 1946), p. 36.

responsibility of the head of the internal auditing department.

From the results of the survey, it can be seen that there is a great diversity in reporting. However, this diversity may not have been as great if a standard definition of the job was used instead of the title of office held. Executives functioning in the same capacity may have altogether different titles. Notwithstanding this one drawback, the tabulation does show a definite trend towards reporting to the controller or the treasurer. The number of heads of internal auditing groups reporting to these two officials, made up over half of the companies surveyed.

Mr. T. W. Spicer, Chief of Auditing Methods and Results Western Electric Company, also made a survey on the same subject. He questioned the heads of the internal auditing departments of eight companies. Of these companies covered, it was found that in two cases the chief auditor reports to the treasurer and in the other six, to the controller.

Mr. Spicer questioned the auditors as to their own private views as to their preference of reporting responsibilities. All of the chief auditors felt that they were experiencing no difficulty under the present arrangement and that their independence was not being restricted in any manner. It was the consensus that the treasurer and the

Table 1

Reporting Responsibilities Of
The Heads Of 163 Corporations

Reported To	Number	Percentage
Board of Directors	10	6.1%
Board of Directors and President	2	1.2
President	17	10.5
Vice-President (Including Executive Vice-President)	10	6.2
Vice-President and Treasurer	5	3.2
Vice-President in Charge of Finance	1	.6
Vice-President and General Sales Manager	1	.6
Vice-President of Works	1	.6
Controller	66	41.0
Assistant Controller	4	2.4
Treasurer	23	14.2
Treasurer and Controller	4	2.4
Assistant Treasurer	3	1.8
Secretary and Treasurer	1	.6
Secretary and Assistant Treasurer	1	.6
General Auditor, General Auditor-Home Office, Auditor of Company Home Office	3	1.8
General Manager	3	1.8
Chief Accountant	1	.6
No answer	6	3.8
Total	<u>163</u>	<u>100.0</u>

G. T. Bodman (chairman), "Report of Industrial Committee", The Internal Auditor, (June, 1945), pp. 58-59.

controller are more cognizant of the accounting and financial problems which make up a great part of the internal auditor's work. They further expressed the opinion that the modern controller and treasurer's duties and responsibilities are not confined strictly to the limits of accounting and financial matters. They are regarded as executives of the corporation as a whole and can be instrumental in

effecting an expansion of the internal auditing effort beyond traditional boundaries where such expansion is warranted.

The attitude of the officer to whom the internal auditor reports has a direct bearing on the value of the work of the internal auditing group. Unless the officer maintains an open mind and an attitude which encourages critical appraisal, the work of the internal auditor will be greatly hampered. Unless he thoroughly reviews the reports and backs up the findings of the auditor by promptly following through on the recommendations made, the work of the auditing group will fall into a mere mechanical verification of arithmetical data.

Management should fully impress upon all members of the internal auditing group that it wants critical comments on all phases of the operations surveyed. It should also state that management will protect the internal auditor from the effects of warranted criticism that he may make on any phase of the company's operations.

Strong and active backing by management also impresses on the operating personnel that the internal auditor is a representative of management. When the operating personnel understands that management will support the internal auditor both as to his rights to seek out facts and to review and take action on the findings, the operating personnel will give greater cooperation to the work of the internal auditing group.

CHAPTER IV

THE INTERNAL AUDITING DEPARTMENT

Departmental Functions

The original functions of an internal auditing department were those functions related to the verification of accounting transactions designed to safeguard company property and to the maintaining of established standards of accounting. While the internal auditor's duties have widened, the importance and need of proper and continuous attention to these original functions have not diminished.

As a broad survey of the scope of the functions of the internal auditing department, Reitzel gives the following description:

The scope and range of the work of the internal auditor is broad. Not only does he audit vouchers, reconcile bank accounts, confirm accounts receivable, verify inventories, check many other transactions, but in addition, he is called upon to appraise properties and make other investigations for the determination or preservation of company's interest. On many occasions, the auditor is charged by management with delicate missions requiring the utmost tact and diplomacy. There are many times when he is the accountant, the appraiser, the inspector, the adjuster, the pioneer in a new district. His special assignments are in such variety that no general description of them can be given. (1)

- (1). F.S.Reitzel, "Modern Internal Auditing", Internal Auditing a New Management Technique. Stamford, Conn: Brock & Wallston, 1943), p.9.

The basic functions of business may be grouped into four main types; directive, operative, service and control. The definitions of internal auditing as given in the earlier chapters definitely places the work of the internal auditing department in the category of a control function.

The control function may be broken down into four basic elements. These are:

1. Well established and clearly written pre-determined objectives.
2. Written procedures which specify the manner the objectives will be obtained and placing the responsibility for their attainment.
3. Standards of performance should be pre-determined for each step of the procedures.
4. Appraisals to be used to determine whether results have been up to standards and whether the action has been taken according to the procedures.

The internal auditing function is involved with all four elements listed above. Its relation to the first three functions is through appraising the written procedures and recommending improvements in the procedures and standards as an aid in achieving the pre-determined standards.

However, it is in connection with the fourth element, the appraisal function, where internal auditing can be of the greatest service. The internal auditor appraises the results against pre-determined standards of

performance for the attainment of pre-determined objectives in accordance with the written procedures.

Brink breaks the major control responsibilities of the internal auditing department into six broad functions.

These functions are:

1. Activities dealing with compliance
2. Conservation of resources
3. Verification and analysis of data
4. Appraisal of procedures and allied matters
5. Training and other aids to company personnel
6. Miscellaneous services. (1)

The functions dealing with compliance makes the internal auditor responsible for investigation of the application of and adherence to established policies of the company. The function of appraisal of compliance by operating units makes the internal auditor responsible for being thoroughly familiar with both the basic company policies and the various functional operating procedures. The internal auditor's knowledge should qualify him to appraise the effectiveness of policies from an over-all viewpoint of the company as a whole. He should be able to recognize all violations and bring them to the attention of management. His appraisal should be constructive, resulting in definite recommendations for the necessary improvement or modification of policies and procedures needed to meet changing conditions.

(1) Victor Z. Brink, Internal Auditing, (New York: Ronald Press Co., 1941), p. 22.

In recent years, due to the increase of governmental regulations, the responsibility of investigating compliance with governmental laws and directives of various agencies has been added to the internal auditor's functions.

Investigations of compliance with the established organizational structure should come within the scope of the internal auditing function. Even when this responsibility is not specifically placed on the internal auditing department, the internal auditor should determine that the defined responsibilities and limits of authority are being adhered to as a part of every audit. In cases where conflicts of authority are discovered, the internal auditor should recommend changes or clarification of responsibilities that are needed in the interest of efficient operations.

The second major function, the conservation of assets, covers the prevention of waste of assets through regular operations, the detection of frauds and dishonesty of all kinds and the prevention of losses through mishandling of external transactions.

The internal auditing department's responsibility for the detection and prevention of frauds and dishonesty is often over-emphasized in the minds of the average person into being the sole objective of auditing. This responsibility should be considered as only a minor portion of the internal auditor's entire responsibility. Auditing activities have definite limitations in prevention and detection

of fraudulent transactions. From a cost standpoint, fraud detection is only practical to a reasonable degree. The modern concepts of internal auditing and its responsibility relative to internal control places the emphasis on fraud prevention rather than fraud detection.

Losses in value of company assets may result from inefficient handling of receivables, improper care of merchandise and operating supplies, improper protection of fixed assets, and in any other inefficiencies which may develop out of defective methods, routines or procedures. It is the function of the internal auditing department to recognize all sources of monetary losses to the company and to recommend ways of stopping the losses.

The conservation of assets includes the function of protecting the company's interest in all transactions with parties outside the organization. This function may include such operations as seeing that sales are properly billed or that the services or materials purchased by the company lives up to procurement specifications. Relationship covered by contracts, royalty agreements and leases, should come under the auditor's investigation in order that the company's interests be protected in the interpretation and observance of the contracts.

The third function or responsibility of the internal auditing department, is the verification and analysis of data. Since management bases its decisions on the data furnished by the various departments, it is important

that the data be accurate and analyzed to be of the greatest use to management. The function of analysis of data by the internal auditing department includes the service of interpretation of trends and highlights for management's benefit. The internal auditor's contract between the accounting source and the management function, who is to use the data, places him in an especially ideal position to present the data so that the facts of the reports will not be obscured by the details and to make recommendations based on the figures.

It is in the field of verification that the internal auditor comes into contact with the outside auditor. Many companies have working arrangements whereby part of the detailed verification and valuation of assets is performed by the internal auditor in accordance with a program established by the outside auditor. It is then the function of the internal auditing department to cooperate fully with the outside auditor. While the work of the internal auditor supplements the work of the outside auditor, it should be understood that it does in no way supplant it.

The function of the internal auditing department of appraising the procedures and allied matters overlaps to some extent the functions of appraising the activities of compliance. However, appraisal also includes the function of making constructive suggestions or revisions of procedures resulting from the detection of weaknesses or deficiencies in the procedures or policies. In most instances, the

internal auditor is not qualified to develop procedures outside of the field of financial control, but his services can be used to advantage in the factual investigation of the effectiveness of the procedures.

The internal auditor should be well versed in all of the phases of company policies and plans. Since the scope of the work of the internal auditing department takes the auditor into contact with all departments, he should be well-qualified to fully comply with the functions of training and furnishing other aids to company personnel. He should be well-qualified to explain and interpret current policies and practices to the individuals with whom he comes into contact during the course of his work. Since the internal auditor's work is company-wide, his functions of training employees would include the notification of the employees of the various departments of new and more efficient practices that may have been initiated in other units of the company.

The functions of performing miscellaneous services will vary between organizations. This service may include special investigations or analyses for management. It may include the performance of special co-ordination work between the various departments, units, or plants. For the most part, these miscellaneous services take the form of direct aids to management. The types of services rendered will depend on the desires of the managerial group and the qualifications and status of the individuals who compose the internal auditing group.

Internal Auditing Staff

The services rendered by the internal auditing department varies in direct proportion to the qualitative and quantitative make up of the internal auditing department.

However, no matter how large or how well-qualified the internal auditing department may be, it will not fully succeed in accomplishing its objectives unless it is motivated by a proper viewpoint of its place in the corporate organization. The members should consider themselves as an arm of management; with their prime objective to aid management to achieve the objectives of the organization.

A great many internal auditing departments have been initiated at the suggestion of the outside auditors. In many cases the department was built around a man or a group of men who had received their training in public accounting.

Current practices with regard to adding new members to the internal auditing staffs vary greatly. At one end of the scale are those who advocate obtaining auditing talent solely from outside the organization. The argument put forward in support of this stand is that men from the line organizations are not suitable for internal auditing because they do not have and do not readily acquire the auditing viewpoint. It is said that men from line organizations are too disposed to waive minor departures from company instructions as being immaterial. It is further argued

that they have a strong tendency to pass loosely controlled routines in the name of practicability, and in general they are more impressed with standards of production than with standards of inspection.

At the opposite extreme of this thinking in regards to the best supply for future members of the internal auditing staff, are those who prefer to obtain all of the auditing candidates from other departments of the company. They argue that by recruiting from within the company, they are able to obtain people who understand the company's organization and problems. They also argue that they are also able to obtain men who have a broader viewpoint than that of the traditional auditor, with little or no operating experience, who is apt to be overly meticulous. It is further felt that a better knowledge of his work and judgment of his ability is available when a man who is already in the company is placed in the auditing organization.

In speaking of recruiting future internal auditors from within the company, P. D. Lipscomb makes the following observations:

In the interest of company men, I think that it would be well to make it generally known throughout your organization, that there are certain educational and technical prerequisites to be met by junior internal auditors, and the extent to which these qualifications may be acquired by ambitious employees on the job in other departments. The company man who studies after working hours to acquire these qualifications, will come to you with the best kind of evidence of initiative, determination and persistency, as well as with a working knowledge of your

company's operations. (1)

The internal auditing department of a large oil company has made it a practice to recruit outstanding men from the accounting and operating departments regardless of rank or salary status. A definite limitation of two and a half years has been placed on the time that they will spend in the internal auditing department. At the end of that time, these men are then transferred back to their previous department or to some other department in the company. The timing has been arranged so that the impact of the transfers from the auditing force is kept at a minimum. The company employs direct and vigorous supervision over the auditing crews. The auditors work in teams, with each member educating the others in the type of operations related to his previous experience.

This company states that the high type of men they acquire through this method of selection are enthusiastic at having a specific period in which to gain the broad additional training gained in internal auditing work. At the end of the two and a half years of auditing work, these men are eagerly sought for by department heads throughout the company.

- (1). P. D. Lipscomb, "The Selection and Training of Internal Auditors", The Internal Auditor, (September, 1944), p. 27.

There are a great many companies that use both sources within the company and sources outside of the company for new talent. They feel that a staff composed of both elements working together tends to compensate for the deficiencies that may be caused by obtaining all of the candidates from one source.

In reporting on a survey of practices among internal auditing departments as to the training value of the work for personnel from other departments, Spicer made the following comments:

The majority of the companies surveyed felt a necessity for providing frequent exchanges between auditing and other organizations of the company to build up the potential value of the individual, and generally felt that they could probably do more than they are now doing along this line. There is apparently a natural struggle between the desire to produce a higher type of employee for the company as a whole (recognizing the value of the internal auditing as a training ground) and the sense of responsibility of doing an effective audit job with an experienced and stable force. (1)

In the same survey of internal auditing practices, Mr. Spicer inquired as to the number of members that were on the staff actively engaged in auditing. The survey made of eight companies showed that the average staff had about one auditor for every 1000 employees. A traditional rule of thumb is often cited which says that there should be one auditor to every thousand personnel.

(1). T.W.Spicer, "A Survey of Internal Auditing Practices", The Internal Auditor, (June, 1949), p. 15.

Mr. Spicer remarked that he speculated as to whether the knowledge of this superficial ratio set up by this rule of thumb may not have unconsciously been an influence in the determination of the size of the audit force in some cases.

It is felt that such an arbitrary ratio should not be used. The internal auditing groups' place in the organizational structure, the scope of the internal auditing responsibility, and the type of operations varies to such a great extent between companies, and plays such an important part in determining the staff needs that no iron-clad rule can be made. It is further felt that qualitative element of the staff also plays a part in determining the number of men needed. As a result, it appears that the number of auditors in each department must of necessity be determined on the spot with due regards for all the conditions that have a bearing on the decision.

Staff Personnel Qualifications

The job description for an internal auditing staff may be divided into two or three levels. In cases where there are three levels, the jobs are classified as Junior, semi-Senior and Senior Auditors. On staffs where only two classifications exist, the semi-senior classification is omitted and the higher classification is often given the title of auditor.

A typical example of the job description for a Junior Auditor's position in a company which maintains only

the Junior Auditor's position in a company which maintains only the Junior and the Senior Auditor classification is given below.

The Junior Auditor, under the guidance of an auditor, examines the more routine accounting processes, books and records prepared by accountants and clerical workers in the assigned plants and offices to verify the accuracy and adequacy of entries in the books; he investigates errors and discrepancies, questioning others on matters where the facts or records are not substantiated; and reports the facts disclosed. He reviews the findings and comments pertaining to plant examinations with the auditor for inclusion in the consolidated plant audit report.

For appointment to the position of Junior Auditor, the average job description gave the educational requirements as that of a college degree with a major in accounting. The experience requirement is set at one year as a junior accountant in a plant or a related field of activity. The typical job description states that a year and a half is needed to gain proficiency on the job.

In estimating the breakdown of the time spent by the junior auditor on the various major activities, the listing shown in Table 2 is given:

Table 2

Analysis of Time Spent
By Junior Auditor

<u>Activity</u>	<u>Estimated Percentage of Time Spent</u>
Examinations	70%
Analysis	10
Interviews	10
Reports and Recommendations	10
Total	<u>100%</u>

A typical example of the description of the duties of an auditor is set forth as follows:

He examines, analyzes and criticizes books, records, or accounting methods in assigned offices and plants; he investigates receipts, warrants, vouchers, authorizations and other evidence supporting the entries in the books; he questions others on matters where the facts on records are not substantiated. He prepares reports with supporting exhibits and schedules, setting forth facts, findings and comments regarding audits. He makes recommendations which will be of assistance in determining policies and procedures to be adopted in meeting situations revealed by audits or in improving records and accounting methods. He directs junior auditors in making plant audits.

The experience requirement needed to attain the position of a Senior Auditor is two and a half years as a Junior Auditor.

The breakdown of the percentage of time spent on

the various elements of work by the Senior Auditor is set forth in Table 3:

Table 3
Analysis of Time Spent
By Senior Auditor

<u>Activity</u>	<u>Estimated Percentage of Time Spent</u>
Examinations	50%
Interviews	10
Analysis	15
Reports and Recommendations	20
Personal Administration	5
Total	<u>100%</u>

While the above job descriptions place the greatest emphasis on auditing, the accounting records, the internal auditor is supposed to maintain a viewpoint of critical appraisal of all elements of management with which he comes into contact. The process of expanding the scope of the auditor's work is a continuous operation.

As the duties of the internal auditor has broadened, so has the qualifications needed by the internal auditor broadened. In the past, the internal auditor was looked upon as a nemesis of management whose only job was the finding of errors in the clerical work of others.

The internal auditor is primarily a representative of management. It is up to him to do a lot of unofficial helping with all kinds of operating problems as well as making official reports through proper channels. In regard

to the internal auditor's function of cooperating with personnel in other departments, Lipscomb states:

His working relationships with other people are much closer than those of the general accountant. As a direct representative of management, he assumes executive responsibility for the smooth working of the organization. If he is properly trained, his work should be like so much lubricating oil on the operating machinery. If he isn't, it may be like so much sand. (1)

In selecting men for internal auditing, the head of the internal auditing department should aim to recruit men who are best qualified to carry out the various functions of the department in such a way that management will be given the best service possible. He should strive to select alert personnel who are not afraid of hard work and who are honestly desirous of learning the business they are auditing.

In writing on the selection of candidates for internal auditing, Mr. D. B. Mathias lists the necessary qualifications for the prospective internal auditor as follows:

1. Basic educational background
2. Speed in simple mathematical calculations
a great respect for mathematical accuracy
3. A temperament that will permit him (or her) to engage in detailed work without loss of interest
4. Willingness to stand the gaff of exacting personal work when necessary

(1). P. D. Lipscomb, "The Selection and Training of Internal Auditors", The Internal Auditor, (September, 1944), p. 29.

5. Accurate and rapid analytical ability
6. Ability to express ideas in a concise and understandable manner
7. Imagination
8. Fearless honesty
9. Sound judgment (1)

Mr. Mathias pointed out that no attempt was made to list the above qualifications in the order of their importance.

As a basic educational background, the internal auditor should have a thorough grounding in accounting. In addition to accounting, he should have a good knowledge of management, organization, industrial engineering and personnel. To round out his background, the auditor should be acquainted with such subjects as economics, marketing, business law, corporation finance and the history of business. The purpose of a broad academic background is to provide basic knowledge and to increase the individual's capacity to understand and correlate the elements of the business activities with which he comes in contact.

Since the work of the internal auditor is the appraisal of work done by the operating departments of the company, the personality factor is very important. The success of the internal auditing program within a company will depend largely on the tact and imagination of every

(1). D. B. Matias, "The Selection and Training of Internal Auditors", Internal Auditing A Post-War Appraisal, (New York: The Institute of Internal Auditors, Inc. 1947), p. 32.

member of the internal auditing staff. The qualities which directly concern the internal auditor's relation with other people must be a prime consideration in the selection of the internal auditor.

The qualifications which have a direct bearing on the quality of the work of the internal auditor, is his ability or inclination in the field of analysis and investigation. He must possess an analytical sense in order that figures can be visualized in relation to the events and current realities they represent. He should have sound judgment along with his analytical ability in order to evaluate the various factors involved in the investigation and in order to weigh their significance and determine their order of magnitude.

Relationships of Internal Auditing Department

As noted above, the internal auditor should possess a wide background of knowledge of company affairs and a wide acquaintanceship among the operating personnel. This acquaintanceship can be built up only through promoting proper relations with the people with whom he comes into contact. During the day-to-day dealings with the personnel of the various departments, the internal auditor must assume the role of accountant, auditor, diplomat and salesman. He should be fully capable of carrying on an understandable discussion regarding the job of every man with whom he comes into contact. He should constantly be aware of the all-

important happenings of the organization and should constantly attempt to broaden the scope of his knowledge by appropriate information seeking.

Every contact made by a member of the internal auditing staff should gain friends and instill mutual respect between the departments involved. In making trips to outlying plants, the internal auditor should foster friendly relations with all the personnel with whom he comes into contact. Many large corporations have been built as the results of combinations of several independent industrial units. In such cases the Chief Auditor and his staff are in an ideal position to aid the over-all control of management by promoting the company-wide viewpoint, thus over-coming sectional jealousies. The internal auditor's work of reviewing the records and the methods of compiling data can be an important factor in instituting standardization of company's procedures and methods.

In speaking of dealing with the various operating divisions of the company, Mr. F. B. Nicholson stresses the importance of tact and diplomacy in all relationships by making the following observations:

The auditor should keep in mind that he must at times be willing to compromise. For example: He has 30 recommendations to make, 5 of which are major control factors. It is absolutely necessary that these 5 controls be established; however, the remainder are comparatively minor. It would be well, therefore, to approach these recommendations in such order as to permit some of the minor points to be

allowed so that when the major problems are presented the auditor will have already established the spirit of compromise. Generally, the plant manager will then agree to the major recommendations. (1)

The internal auditor should keep uppermost in his mind in all dealings, that he is performing a staff function.

His responsibility entails making certain recommendations that he may consider necessary as the results of his review. However, he does not possess the line authority to force the acceptance of these recommendations. His attitude should be that of constructive appraisal, and his recommendations should be of sufficient worth that the operating personnel will clearly see the value in accepting them. Quite often the tact of the internal auditor is severely tested when he is trying to correct conditions, which he considers to be inefficient or wrong. In this connection, Nicholson says:

If a major change is contested, he must not permit himself to attempt to force the issue, but should tactfully indicate that, under the circumstances, top management's decision be requested, which would mean presentation in the report of the difference of opinion. But, regardless of the importance of the recommendation, the auditor should not permit

- (1). F. B. Nicholson, "The Relationship of the Internal Auditor to Other Members of the Organization, "Internal Auditing A Post-War Appraisal", (The Institute of Internal Auditors, Inc., New York: 1947), p. 21

the discussion to become heated. (1)

The internal auditor should be considerate and courteous at all times. He should not jump to conclusions nor show exultation when errors are found. The results of all examinations should be kept confidential and discussed with only the head of the department being audited. In presenting his findings, the internal auditor should make every attempt to prevent anyone from being held up to ridicule or embarrassment.

The internal auditing staff must base their dealings with other departments on a firm foundation of human relations. The internal auditor should constantly remember that his prime responsibility is to see that the policies, procedures, and methods are being followed along the lines laid down by management. He should consider this so-called policing function in the light of what corrections can be made to aid top management in achieving its objectives, rather than in the light of finding errors for the sake of discrediting an individual.

The relations of the internal auditor to the other departments is that of a salesman. The internal auditor must be constantly selling, not forcing, the correct procedures to the other departments.

- (1). F. B. Nicholson, "The Relationship of the Internal Auditor to Other Members of the Organization", Internal Auditing A Post-War Appraisal, (Institute of Internal Auditors, Inc., New York: 1947), p. 21.

CHAPTER V

APPRAISAL OF POLICIES AND PROCEDURES

Administration should proceed according to policies and methods set forth by the various phases of management. In a large enterprise, the quantity of policies and procedures attain a considerable proportion. For the administration function, they act as guide posts in the same manner as specifications do for the fabrication of a product. The establishment of policies and procedures is intended for the promotion of effective administration. In proportion to the failure of the members of the organization to observe these policies and procedures, the effectiveness of the organization is impaired. It is the responsibility of every supervisor to see that those to whom he has delegated responsibility observe the established procedures and policies affecting their particular field of operations. However, supervision will suffer failures from time-to-time and from place-to-place. As a result of these failures, it is often necessary to overcome the defects of supervision through the establishment of an independent appraisal agency to review the operations and to see that all of the policies and procedures are being observed.

In writing of the need for a way to correct the defects that often arise in the supervision function, Mr. Alvin Brown, Vice-President of Johns Manville states:

The principal executive or his chief deputies might make provision for a number of responsibilities to observe the manner of execution of policy and method affecting this or that element of administration. The possible number of such delegations is limited only by cost and by the requirements of supervision. In auditing, however, there is already an eye which, by the nature of its task, is obliged to see into many parts of the enterprise. Why not, rather than provide other eyes, direct that same eye into all parts of the enterprise. (1)

Mr. Brown points out that it would be impractical for the auditor to have a technical training in all phases of the business with which he comes into contact.

However, the more technical operations seem to require no special appraisal agency since these operations are usually quite well unified and are under close supervision of the responsible parties. Moreover, such operations can be regulated by certain predetermined standards and gauges as the operation is being performed.

As pointed out above, the major control problem confronting top management is seeing that the established policies are properly understood and carried out at all levels of management. The problem of securing proper compliance with policies and procedures is related to the size of the organization. In speaking of size of the organization, not only should the financial size of the organization be

(1). Alvin Brown, Organization of Industry,
(New York: Prentice-Hall, Inc., 1947)
pp. 259-260.

considered, but also the complexity of operations, the nature of the activities involved, the extent of the geographical coverage of the operations, the values involved, and the number of people employed.

The responsibility of the internal auditing staff in the field of policy control may be broken down into three classes. The first responsibility is to check on the distribution of information on policies and procedures and to see that such information reaches all executives and employees concerned. The second responsibility is to review and appraise the channels of information to determine that once the personnel concerned receive the information that they understand and follow the policies and procedures. The third responsibility is that the internal auditor should be constantly alert to situations where the present policies are inadequate and recommend the corrections he believes necessary. The internal auditor should also be alert to operations not covered by written policies or procedures and make the necessary proposals to cover those operations.

Appraising Lines of Information

During 1939 and 1940 the Graduate School of Business at Stanform University made a research study of the management practices of thirty-one leading industrial corporations. The corporations covered had total assets, as shown by their published balance sheets, ranging from a

little less than \$100,000,000 to approximately \$900,000,000. The number of employees ranged from 5,000 to 70,000, with an average of around 27,000 employees per company. (1)

One of the startling discoveries made by this survey was that among the thirty-one companies studied, only a few followed the practice of assembling statements of company policy into a policy manual. A few of the companies issued policy declarations in bulletins, general instruction or letters from top management to the executives concerned. Others simply passed policy statements down the executive scale by word of mouth.

These findings definitely point out that the promulgation of policy is a prime problem in modern business organizations. It further points out that the proper flow of information has not always been recognized as a necessity for efficient operations, thus, proper methods for assuring a steady flow of information from the President down have not been instituted.

In reviewing compliance, the internal auditor should first determine whether the avenues of information are open to all departments. They should make recommendations to management on ways that the distribution of policy may be improved. One of the best ways of assuring

- (1). Paul E. Holden, Lounsbury S. Fish, Hubert L. Smith, Top-Management Organization and Control, (Stanford, California: Stanford University Press, 1948), p. ix.

proper distribution of policy and procedure information is to require the keeping of a policy manual by all the department heads concerned. As a part of every audit, the internal auditor should assure himself that the policy manual of the unit or department being audited is complete and thoroughly up-to-date. The internal auditor should investigate all cases where the manual is not in agreement with current issues. This investigation should be made to determine whether the portion of the manual which is not current has reached the department head concerned, or whether the flow of information had been blocked elsewhere. In cases where it is found that the information had never reached the department, the internal auditor should notify management of this breakdown in the flow of information. It is only through this type of appraisal that management can be assured that all units have available current information as to methods and procedures.

Surveying Policy Compliance

In order to maintain proper control over all the functions of the organization, management must have some means of determining the extent of compliance with the various methods and procedures which govern the functions. Non-compliance is often the result of a misunderstanding of a rule or procedure. If the surveying or reviewing agency has a proper background, it should be able to correct all misunderstanding of procedures as they arise. The training

and the background should equip the internal auditing staff so that it can be the unit responsible for communicating top management's desires by aiding the various departments in correctly interpreting policies and procedures.

In speaking of compliance with company procedures, it should be again pointed out that the internal auditing group does not normally exercise line authority over the matters or the procedures under review. In the event of non-compliance with existing policies or procedures, the internal auditor does not have any authority to take direct action to correct the department or unit in error. It is the responsibility of the internal auditor to properly report the lack of compliance of the unit being audited to the person who exercises line authority over the unit.

In regard to the agencies used for appraising policy and procedure compliance, the survey made by the Stanford University Graduate School of Business found that:

None of the companies studied seem to have hit upon any inclusive scheme by which policy interpretation or compliance can be checked. Where monetary matters are involved, the auditing staff is the natural and commonly used agency. Some companies go further than this and look to their auditors to check against policy violations in many other directions, such as prices, credits, discounts and purchases. (1)

The subject of compliance to the various organizational and operational procedures may be divided into

(1). "Ibid", pp. 82-83.

three main categories. These are: Compliance with accounting procedures, compliance with operating procedures and compliance with governmental regulations and requirements.

Since the auditing procedures used by the internal auditor have their bases in the field of accounting, the internal auditor has a prime responsibility for reviewing the compliance by all departments and units with the accounting procedures. In setting up a system of internal control for the protection of company assets and for managerial control, certain routines are set down to be follows. It is the internal auditor's responsibility to see that these routines are being followed in all accounting transactions. It is the internal auditor's further responsibility to report to management any failures in the routines established for the maintenance of internal control and to recommend means of correcting these failures.

Procedures are established designating the various individual forms, journals, and ledgers to be used so that the accounting system will function in the desired manner. The final summation of the accounting data depends on all departments following the same procedures and methods in the manner desired by management.

When operations are spread over a wide geographical area, the chances of different accounting procedures and methods being used is greater than when operations are centralized. The reliability of data for comparison purposes is greatly lessened when the methods of compiling the

reports and statements at the various locations are not standardized. The internal auditing department is in an ideal position to determine whether all the units are complying with the standard procedures and to report such non-compliance to management. The internal audit department is the focal point for all of the information obtained by the internal auditors in their review and appraisal of the various plants; thus a company-wide viewpoint of accounting can be obtained.

Since accounting data is merely a record of operations, the verification of compliance with the accounting procedures is often related to the verification of the compliance with procedures of a distinctly operating nature. In speaking of this interlocking relationship, Brink observes the following:

Where one type of activity ends and the other begins is in fact difficult to say. For example, take the case of material requisition. This form is a part of the accounting system in that it develops a record relative to the issuance of material and establishes the needed accountabilities. At the same time the identical form relates to operating procedure and general factory operation. (1)

The internal auditor should have a fairly broad knowledge of the production methods of the company since he will come in contact with activities of a purely operating

(1). Victor Z. Brink, Internal Auditing, (New York: The Ronald Press Company, 1941), pp. 24-25.

nature. In cases where the appraisal of the operating functions does not require a technical knowledge, the internal auditor is expected to recognize any lack of compliance with existing procedures and policies. He should report such non-compliance with operating procedures to management in the same manner as non-compliance with accounting procedures.

Governmental regulations of private enterprise has increased so rapidly in recent years that compliance with these regulations is becoming a definite problem for management. Since certain of these require the submitting of many reports to the various governmental agencies, internal auditing has a prime responsibility to aid management in complying with the regulations. The internal auditing responsibility is basic in that through it management must be assured of the accuracy of the data that makes up the reports. In the process of auditing, the internal auditor should be constantly alert for any deviation from the requirements.

During World War II, governmental regulations entered into all phases of operations; production, finance and personnel work were all regulated to a great extent. It was during those war years that the full importance of the internal auditing function in assuring the compliance with existing regulations was clearly impressed on management. Since the war, the internal auditing department has continued to play a major role in the important function of assuring

management that the organization is operating within the law, and that the statements submitted to the various regulatory agencies are accurate and convey the proper data.

In the process of reviewing procedures and policies, the internal auditor may uncover situations in which the procedures or policies set by top management are not applicable to current operating conditions. When such discoveries are made, the internal auditor should recommend changes which he considers necessary in order to bring the policies or procedures into line with current conditions. The company-wide scope of the internal auditor's analytical work should place him in a good position to point out errors in existing procedures. He is not bound by the narrow confines of a departmental viewpoint, but has a company viewpoint whereby he can see the effect of the procedure on individual departments as well as the net effect on the entire company.

The internal auditor's work by established procedures, or are covered by procedures which vary from department to department. Contact with such situations will often bring out the need for a standardization of policies or procedures for all departments and units of the organization. Once again the internal auditor's background of reviewing all of the operations of the company places him in a position to point out the best procedure or policies in use.

Development and Installation of Procedures

There is some difference of opinion as to the part the internal auditing group should play in the development and installation of company procedures. One school of thought holds that since the internal auditor is constantly at work critically appraising the policies and procedures currently in effect, he is the ideal man for the development and installation of new procedures. This school of thought further states that the internal auditor's work covers all departments; thus he is in a position to best judge how the installation of a procedure in one department will affect the operations of the other departments. They further argue that the viewpoint of constructive appraisal which the internal auditor should maintain gives him the proper outlook on developing and installing policies and procedures.

The opposite point of view holds that if the internal auditor is to be accepted as an appraiser of the efficiency of methods and procedures, as authority indicates he must be, there is a contradiction of fact between the appraisal duty and any duties he might undertake in originating procedures. The latter point of view seems to have a greater weight of logic and a larger number of followers than the former. This difference in viewpoint as to the duties of the internal auditor is discussed to a greater extent in Chapter VIII - Installations and Improvements of Accounting Systems.

CHAPTER VI

CONTROL OF ASSETS

In stating the responsibilities of the Internal auditor, one of the major phases of the related activities is stated as follows:

The protection of the interests of the organization, including the pointing out of existing deficiencies to provide a basis for appropriate corrective action.(1)

The attainment of this objective involves certain activities which make up the work of the internal auditor. The appraisal and review of the control of assets is one of these major activities.

The term "Control of Assets" is used to indicate that all assets are properly cared for and that precautions have been taken to prevent fraud and defalcation as far as is possible. Control of assets also covers transactions with agencies outside of the company to determine that the company's interests are protected at all times. Thus, the control of assets covers all divisions and all phases of operations of the company.

Company policies and procedures are established for the control of assets. It is only through full compliance with these policies and procedures that the resources of the company can be properly protected and accounted for.

(1). Statement of Responsibilities of the Internal Auditor, The Institute of Internal Auditors, Inc., New York: 1947).

While the control of assets is based on proper formulations of policies, this control cannot be guaranteed unless there is a frequent review and appraisal of the application of the established policies and procedures.

Since the problem of asset control is company-wide, the scope of the work of the internal auditing group makes it the logical unit to appraise the system of control of assets. The internal auditing function does not replace the system of internal control in the protection of assets, rather it acts as a supplement to the established system of checks and controls.

The two major objectives of the internal auditing function is the protection of the company's interests by first pointing out deficiencies in operations and secondly by recommendations of changes for improvement of the operations. These two objectives involve the appraisal of all phases of operations. Thus, the measures that are directed at assuring efficiency of current operations should be interwoven with the system of internal control.

The problem of the control and the protection of assets will be treated under the following main groupings: fraud and defalcations, conservation of assets and the control of assets in outside transactions.

Fraud And Defalcation

Fraud is an ever present problem management and should be so recognized by management in planning for the control of assets. It has been estimated that the losses from fraud range from \$400,000,000 to over a billion dollars annually. (1) For the most part, only frauds involving large amounts make the headlines and become widely known. For every fraud that reaches the papers, there may be a thousand in which the sums involved do not warrant prosecution. The number and extent of frauds which are not discovered cannot be even approximated.

In the preface of his book on embezzlement, Keller makes the following statement:-

Embezzlement is definitely on the increase and improved accounting systems and internal control procedures can assist in curtailing these insidious losses amounting to hundreds of millions of dollars annually suffered through dishonesty; and internal control as a tool of management, can assist in effecting more efficient operations, thus creating a better service, reducing operating costs, and automatically increasing profits. (1)

The internal auditing function has a direct bearing on the protection of the company's assets from fraud since the work of the internal auditor is inseparable from the workings of the system of internal control. In the past,

(1). "Ibid", p. 1.

the sole function of the internal auditor was the policing of the accounting records. While the internal auditing staff remains the prime agency in the review and appraisal of the accounting records, the concept of the internal auditor's relationship to the fraud problem has changed in recent years. In the past, the function of internal auditing was often considered solely from the point of fraud detection. The new concept is that of prevention of fraud. The safeguarding of the company's assets from fraud is now the result of the internal auditing function rather than the objective, as it was in the past. To rephrase an old saying, the internal auditor is interested in locking the barn before the horse is stolen.

The modern concept holds that it should be the responsibility of the internal auditor to appraise current procedures and routines to determine if every effort has been made to prevent fraud and defalcation. In cases where the control of assets are not fraud-proof, the internal auditor should make a thorough review of the system and make recommendations for the improvement of the internal control.

In writing on the place of the internal auditor in fraud prevention, Thurston says:

It is my belief that the internal auditor, as the company's expert on internal check, should be required to review all new systems and procedures from the standpoint of internal check, and, in addition, should study layouts and functional designs where these impinge directly on matters of internal check. Where the system of internal check is properly

designed and adequately maintained, opportunities for fraud are reduced by a substantial extent. (1)

In thinking of fraud, the mind tends to concentrate only on the larger amounts involved in defalcations. However, the daily pilfering of petty sums can in time amount to a very large loss. The question is sometimes raised as to whether it is worth the time, the effort, and the expense of having the internal auditing group tracking down the fraudulent taking of small amounts. Thurston answers this question in the following manner:

Most certainly, and for this reason: a great majority of frauds start with small, temporary "borrowings". If the "borrower" finds he can get away with a small sum, he then tries for a larger amount and finally reaches the jackpot. In many instances he gets away with it; he has the foreknowledge that only a slip on his part or bad luck will trip him up, because the company has shown him that its failure to provide an adequate system of internal check and its lack of proper internal auditing is his best assurance that his fraud will go undetected. (2)

Many times management feels that since they are covered by fidelity insurance, they are fully protected from the loss resulting from fraudulent acts of their employees. They feel that the payment of the insurance premiums is sufficient expense and that the additional payment for the work of the internal auditing group to prevent and detect

(1) J.B.Thurston, "Fraud As A Major Management Problem", Internal Auditor, (June, 1949) pp.37-38.

(2) "ibid", p. 40.

fraud is actually working at cross purposes. They feel that they should have one or the other, but not both.

If sufficient thought is given to the matter, it can be seen that actually fidelity insurance and the internal auditing function work as a supplement, one to the other. Insurance is designed to re-imburse the company for losses suffered. The internal auditing work is designed to prevent or detect the fraud before the losses have reached a considerable amount.

In a survey made of 1,001 cases of defalcation, it was found that the amount of assets lost through fraudulent acts of employees totaled \$6,284,506.49, while the amount of reimbursement from insurance amounted to only \$2,922,316.28. (1) These figures clearly indicate that, while fidelity insurance is designed to reimburse the organization in case of loss, it can do so only if the losses are discovered and if the losses are not greater than the coverage of loss setup by the insurance. Moreover, insurance companies base their premiums on loss experience. If a great many frauds occur, the insurance companies will be forced to raise the rates of the premium charged, thus a given company may be burdened with a very high cost of insurance. In recognition of the fact that internal auditing is a definite fraud deterrent, many of the leading bonding

(1) A. E. Keller, Embezzlement and Internal Control,
(Washington, D.C.: Warner-Arms Publishing
Company, 1946), p. 211.

companies give a reduced premium rate where the organization has an internal auditing staff.

Conservation of Company Assets

The control of assets have some aspects of conservation activities which are not essentially matters of policies and procedures. It is in this field of activity that management must place a great dependence upon the alertness and the foresight of the internal auditing group. The field of conservation may range from activities which cover the handling of raw materials to seeing that undue time is not lost by the workers in going from one activity to another.

In some cases, the control of the assets will be tied in closely with the accounting function, and in other cases this relationship may be very distant. It is in the cases where the misuse of assets will be only indirectly reflected in the accounting records that management has the greatest need for some type of an appraisal agency to determine whether the company's interests are being fully protected.

A well-informed and an alert internal auditing staff with a company-wide responsibility can best answer the need for the appraisal agency. The work of the internal auditor brings him in contact with every phase of operations in all department and units of the organization. The internal auditor's reporting responsibility to management places him in the logical position of calling management's

attention to all instances where company assets are being wasted. The internal auditing staff as an extension of the "eyes and ears" of management should make the misuse of any assets a matter of report.

The internal auditing function can aid management by keeping constantly alert to improving the methods of handling and accounting for all types of assets. The care of fixed assets, the handling of inventories, the control of spoilage, scrap, and waste, and the misuse of time by company personnel are all fertile fields for the internal auditor's work.

Most companies go through a great deal of effort in selecting a new machine or in erecting a new building to see that they are getting an item that will best answer their need and to see that they are getting an item that will best answer their need and to see that they are getting the asset at a fair price. However, once the asset is obtained, few companies have a definite planned program for the care and the upkeep of these machines and buildings once they are placed in use. Usually, no attention is given these assets until a major repair is needed. The internal auditing staff should take an annual or a bi-annual inventory of all fixed assets to assure management that its records of capitalized assets are accurate and up-to-date. As a part of this inventory, the internal auditor should be alert to conditions which clearly show that the assets are not receiving proper care or that they are in need of repair. It is

recognized that the average member of the internal auditing staff does not have sufficient technical background to enable him to note defects in the more complicated types of machinery; but this need is not required in most cases since trained technicians usually are in the control of such inspections.

As a part of every plant audit, the internal auditor should make a complete tour of the plant, noting such items as the need for paint on equipment or buildings, the need for replacement of broken fixtures, the need for repair of flooring or windows, or many other like repairs. While such repairs are not of the major repair classification, action taken in correcting the existing conditions will often add greater efficiency to the operations of the department and prolong the life of the asset. Many times an asset will become obsolete or will no longer be needed by one department or plant. Often the asset will be set aside and no further action be taken to determine if it could be used by other departments of the organization. In his tour of inspection the internal auditor should note such abandoned assets and recommend to management that action be taken to see if the asset has further use in the organization. If it hasn't any further use, the internal auditor should recommend that it be turned over to the salvage department for sale to outside parties.

The breakage and deterioration resulting from improper storage and handling of inventories can be a large element in the reduction of inventory values.

Since the functions of the internal auditing staff involves the observance of taking the inventory counts of the various ware in storage, the internal auditor is in an ideal position to appraise the methods of storage and handling. In order to be of the fullest service to management, the background of the internal auditor should make him especially well-versed in methods of proper warehousing. He should be able to point out defects in the warehousing methods which result in losses, either in ware or time and labor in handling of the ware. Often conditions that result in losses of inventory have been going on for a long time and the warehousing personnel take the defective methods as a matter of course. The fresh viewpoint of an outsider can often throw new light on the matter and aids the personnel to see the errors in their methods. As an extension of the "eyes" of management, the internal auditor can make sure that such matters are brought to the attention of management. The internal auditor is also in a position to check on the warehousing from time to time to see if the conditions have been corrected or if the defective conditions have continued to exist.

The internal auditor should be constantly alert to waste of operating supplies. Control of such supplies is often very hard to maintain since the various units using the same type of supplies may be spread over a wide operating area. The internal auditor in checking the general stores inventories should be constantly alert to the duplication of inventories resulting from having a great many individual

departmental storerooms. He should also investigate the amount of supplies kept on hand by the individual worker. Recommendation should be made to management that departmental storerooms be consolidated in all possible cases.

The internal auditor should review and appraise the methods of purchasing supplies to see if proper quantities are being purchased and if fair prices are being paid. While the supervisors of the operating personnel are responsible for the proper use of supplies by the men under them, the internal auditor should review the use of supplies and report to management how well the supervisors are observing this responsibility. In the average organization there is no unit other than the internal auditing department which is so fully equipped to make a complete appraisal of the usage of supplies.

The lack of control of defective work, spoilage, scrap and waste can result in enormous losses over a period of time. Defective work and spoiled ware results not only in the loss of value of the material, but it also results in the loss of labor and overhead applied to the items.

The internal auditing department should make regular reviews of the production standards to determine if the number of items passed by the inspectors is meeting the predetermined standards.

One of the means of controlling defective work, spoilage, scrap and waste is the active use of written procedures and specifications. However, written procedures

are an effective means of control only as long as they are followed by the operating personnel. Again the work of the internal auditor in the field of appraisal of compliance with existing procedures can serve to keep management informed of an operation which is often overlooked.

In speaking of the appraisal responsibility of the internal auditor in relation to defective work, Bailey makes the following comments:

In making such appraisals, the internal auditor should give particular attention to accounting procedures. He should ascertain whether procedures are adequate and what suggestions should be made for improvement. (1)

The work of the internal auditor also covers the review of the handling and recording of the cost of defective work by the cost department. In this type of review, management can be fully informed of the effects of the cost of defective work on the actual costs of production.

Management of many companies neglects to pay sufficient attention to the operations of the salvage department. Consequently, the maximum benefits that can be derived from the efficient functioning of this department is often lost. The internal auditing function of appraising the operations of the various operating departments and units makes it a logical organization to appraise the operations

- (1. Elmer Bailey, "Control and Audit of Defective Work, Spoilage, Scrap and Waste", The Internal Auditor, (June, 1948), pp. 22-23.

of the salvage function. Since the salvage department is handling material left after the product is produced, management should be fully informed of the action taken in the handling of this residue.

An alert internal auditing department can save management large sums of money by appraising the present activities of the salvage department and by recommending practices by which management will realize the maximum revenue from salvage operations. The internal auditor should investigate the methods of collection, segregation, reclamation, and preparation of the materials for sale. The negotiations of the sale of scrap should be reviewed to see if the greatest return possible is being obtained. The internal auditing staff should have the function of reviewing the salvage operation to see that proper control is maintained over all scrap and waste, the often forgotten assets of the organization.

The work of the internal auditor brings him into contact with operating personnel from every department of the organization. In the course of an audit, the internal auditing staff is brought into close personal contact with the workers in the department being audited as well as with the work performed by these individuals. This close contact should enable the internal auditor to appraise the abilities of the various individuals with considerable accuracy. In the appraisal of the personnel, internal auditing can keep management informed on its greatest asset, the people who

work for the company.

In commenting on the internal auditor's responsibility of appraising the individual employees and their relations with the company, Thurston makes the following comments:

The internal auditor's most important job of observation relates to personnel, an organization's greatest asset, and one that does not appear on its many otherwise well-managed companies, provide for proper custodianship and adequate records of every other asset, but neglect the asset of personnel. In such companies no one is specifically charged with the custodianship of personnel, with its maintenance and upkeep, or with determining when personnel is fully depreciated and requires replacement. (1)

The internal auditor should not only note the individual who falls below standard performance, when the work being audited shows certain defects, but also should highlight the performance of the outstanding individual. In large organizations it is possible for an individual to be performing one job when his capabilities qualify him for a job of much greater responsibility. As a result, management is not making the most efficient use of the talent it has available.

In writing of the internal auditor as an unofficial co-ordinator of ability possessed by the personnel of an organization, Brink makes the following comment:

The internal auditor has in this connection a unique opportunity. Operating as he normally does between individual field offices

- (1). John B. Thurston, Basic Internal Auditing Principles and Techniques, (Scranton, Pennsylvania: International Textbook Company, 1949), p. 48.

and the central headquarters, he is in a position to know what needs for personnel exists in the organization and to associate the employees of particular offices with those needs. This is to the company's advantage in that it gets the best available talent for the various company posts and also that it encourages the entire personnel through the knowledge that such advancement is possible. (1)

The internal auditing functions also make the asset of personnel more efficient by adding a certain psychological impetus to the work of the employee. When the organization knows that the work is to be reviewed by a definite reviewing agency which reports to management, greater effort is expended to assure that the work will approach the standards set by management.

Control of Assets in Outside Transactions

The third type of control maintained over the assets of the organization is that control established for the purpose of protecting the interests of the company in all transactions with parties outside of the organization. This control would extend to all types of contracts, both oral and written, made by the company or for the company. The internal auditing function should be responsible for reviewing the terms of the contract and appraising the relationships created by the contract to determine if all the terms are being fully carried out. This type of review would include such transactions as sales, contracts, procurement

(1). Victor Z. Brink, Internal Auditing, (New York: Ronald Press Co., 1941), p. 362.

contracts, royalty contracts and leases. It is not intended that the internal auditing department should take over the duties of the various departments whose responsibility it is to make such contracts. Rather it is the duty of the internal auditing department, through use of accounting records and other statistical data, to determine whether these contracts have been made and are functioning along the lines of the policies and procedures laid down by management.

Sub-contracting, while it is not carried on to as great an extent as during the last war, offers a fertile field for the internal auditor to render valuable service to management. In sub-contracting for work to be done on a cost plus basis, it should be agreed that the internal auditor be allowed access to the seller's books for the purpose of determining whether full compliance is being made to the terms of the contract. The internal auditor's responsibility should not only extend to a review of the clerical accuracy of the cost calculations and their application to the quantities involved, but also to the interpretation of the contract in regards to the factors used in determining the cost of the various elements of production.

The internal auditor could never be, and should not be expected to be, an expert in all of the technical matters involved in the control of the various assets of the company. However, the internal auditor's background should enable him to observe all of these controls in their proper

prospective in relation to over-all operations. He is not expected to be an expert in all matters, but he is expected to show good business judgment and to be constantly on the alert for all undesirable conditions with which he comes into contact. He is expected to bring to management's attention all transactions and conditions which are working against the best interests of the company.

CHAPTER VII

MANAGERIAL CONTROLS

Internal Control

The accounting system of an organization exists to answer the needs of management for information, protection and control. It is the function of the accounting system to provide currently accurate and suitable information by which management can review past performance, and on which it can base decisions to govern future action. Accounting records establish the accountability of individuals and departments for values of assets under their control. Lastly, accounting through the use of standards, budgets, and predetermined routines serves as an effective instrument of management in controlling all of the various units of the organization. These three functions must be performed in a manner which is most economical and efficient in the light of the expenditure made to secure these objectives. Internal control is a system to aid in achieving the most efficient operations of the accounting function. Internal control is the method adopted within an organization to check the clerical accuracy of the accounting figures and to safeguard the assets of the company.

In this chapter, internal control is reviewed from the viewpoint of its relationship with the accounting function. The definition set forth in Chapter I is the

wider application of internal control that may be applied to any one of the various functions of a business. However, the appraisal functions of internal auditing may be applied with equal benefit to all of the other aspects of internal control as it is applied to the accounting aspects of internal control.

Thurston lists the most important principles of internal control in safeguarding the accounting function as follows:-

1. The duty and responsibility of each executive and employee must be clearly defined to the fullest extent, particularly where assets or transactions are susceptible to fraud. These duties must be distinct and separate.
2. No executive or employee should be assigned the entire charge over both cash or other disposable assets and the records of such assets, except where it is out of the question to handle them otherwise. Only when management has full knowledge of the problem and is willing to take a recognized, measured risk, should this be tolerated.
3. As many executives and employees as possible within the limits of prudent economy should be injected into each transaction, so that, to the greatest extent, the work of one will check that of another and errors and mistakes will have a better chance of being avoided.
4. Whenever a transaction occurs, some memorandum or record that can be checked must be created. Such records should, in most instances, be numbered serially, carefully controlled so as to be used in sequence and accounted for systematically. (1)

(1). John B. Thurston, Internal Auditing Principles and Techniques, (Scranton, Pennsylvania: International Textbook Company, 1948), p. 53.

The following of the listed principles will add definite reliability to the accounting system. However, it should be emphasized that no system of internal control can be considered adequate or complete unless it includes an agency for the appraisal of the routines and procedures. Even if a perfect system of internal control was devised, it would still be necessary to have an agency responsible for the checking of its operation and maintenance. Internal auditing function has the responsibility for reviewing the accounting data; thus, it follows that it is only natural that the internal auditor should be the one to make frequent checks into the operations of internal control. The internal auditor's relations with the system of internal control is so important that it might be said that the internal auditing function is the keystone of internal control.

The internal auditor performs a triple role in his relationship with internal control. These roles are: the ascertaining of the degree of reliability of the accounting and statistical data developed, the reviewing and appraising of the procedures and routines in terms of their adequacy and effectiveness, and the establishment of a check over transactions which must be left exclusively or almost exclusively to one employee or one department.

The old concept of the function of internal auditing give the internal auditor only one rule in the system of internal control, that of a checker of the arithmetical correctness of the records. While the work of the internal

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of internal control, that of a checker of the statistical
correctness of the records. Unlike the work of the internal

auditing staff is still directed at appraising the accuracy of the data reviewed, this appraisal of accuracy is used only as a starting point for an over-all appraisal of all the phases of internal control.

In speaking of the importance of a well-thought-out and a well-rounded program of checking the accounting data, Brink says:

The impression should not be formed that these checking activities are to be regarded lightly. These activities to a considerable extent serve a most useful and necessary purpose. They constitute the basic underlying program of internal auditing and are aimed at specific objectives of internal auditing. What is important, however, is these activities of a police nature should be regarded as a means and not as an end. That is, the major or ultimate objectives of internal auditing are larger than the objective of persevering the immediate status quo, and these checking operations are only the starting point for an additional range of activities and services. (1)

The review of the accounting data should point out certain facts to the internal auditor concerning the adequacy of the system of internal control. If frequent errors appear in the data, a weakness must be present in the procedures or routines in use. The internal auditor should make a thorough analytical review of all phases of the system of internal control. It is his duty to be able

(1). Victor Z. Brink, Internal Auditing, (New York: The Ronald Press, 1941), p. 11.

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to point out the definite reason for these weaknesses, whether they be of the personnel involved or the system in use.

However, the appraisal of the internal auditor should go even further than the review of the current system of internal control. He should review all prospective systems or prospective changes in the present system to determine whether the basic demands of internal control will be fully met.

Budgetary Controls.

As has been pointed out in previous chapters, the degree of success of a business is almost wholly dependent on the quality of its management. In order to successfully direct a business, management must have definite control over operations. This control is obtained only by having an accurate account of the results of operations and predetermined standards to judge the quality of these results. The problems of managerial control is often complicated by the wide geographical area covered by operations and the distance between operating units and the location of top management.

One of the principle means of controlling operations, no matter where they may be located, is through the use of budgets. In the use of budgets, management attempts to set certain plans for future operations and attempts to picture the results if these plans are carried out. Budgetary control provides a means whereby management can plan

all operations for various periods and commit the various departments and divisions of the business to a well-considered performance estimate. Budgetary control supplies management with a means of checking results, uncovering weakness, and making the necessary corrections before it is too late.

Budgets to be effective must be based on certain predetermined standards that reflect past experience, present business conditions and trends and predictions as to future conditions. The close relationship between the activities of the accounting function and the great reliance on the data gathered by the accounting function brings the budgetary control work into the scope of the internal auditor's responsibility.

The internal auditor's responsibility begins with assuring management that data showing the results of operations for previous periods is accurate. This assurance will aid in establishing the reasonableness of the budgetary standards. The internal auditor should determine that all departments compile the data accurately, and that the basis of data compiled by one department is comparable with the data presented by the other departments. The calculation of the budgetary data should be given the amount of analysis and review that their importance merits. If modifications are made in the figures submitted for determining the budgetary standards, the internal auditor should review the changes to determine whether they were made in accordance with reliable

accounting data. Such reviews tend to offset the tendency of departments or units preparing the budgets to leave themselves plenty of latitude in order to be sure of meeting the estimates. The thorough review of the data by the internal auditing group also tends to improve the accuracy and effectiveness of the budgets to the extent that estimated costs are based upon thorough analyses of all activities and functions.

After the budget has been prepared and placed into operation, the internal auditing group should review the budgeted activities. The review should cover three main phases: (1) the control over the items budgeted, (2) the reporting of performance under the standards set by the budget, and (3) review of the variances from the standards.

Management initiated the budget as a method of exercising control over the various functions of the organization. Proper balance and co-ordination of the various phases of operations can be achieved only by knowing how well the operations of the department have conformed to the estimated operations. This conformance or non-conformance to the budgetary standards must be pictured in relation to the other departments of the organization. Thus, management needs an agency that will review the results of operations from the viewpoint of budgetary standards. This agency should note all deviations from standards or definite trends that appear to be away from standards. The budgetary reviewing agency must be alert to determine whether changing

conditions require certain budgetary adjustments, and if they are necessary, to determine to what extent should they be made.

The internal auditor's second interest in budgetary operations is the reporting of performance under the budget. The reports should clearly present all variances and should disclose the reasons for the variances where they are known. The internal auditing group's background of analytical appraisal makes it an ideal unit for determining the accuracy of the data reported. Also, the internal auditing background should enable the group to make suggestions to the operating personnel which may aid in cutting down the detail work on the budgetary reports; thus enabling management to receive prompter reporting of the results of operations.

The third phase of the internal auditor's work is the investigation of the causes for undue variances from the established standards. While the determination of the exact causes for variance is often hard to make, every effort should be expended to determine the reasons for the variances and to make constructive recommendations for correcting the causes of the variance.

Departmental Audits as a Management Control

The internal auditing function itself makes up a control of management. Through performing departmental audits and reporting to management the findings of the audits,

management can be kept informed of operations. It is in the departmental audit that management is able to obtain a control of detailed operations that would otherwise be impossible without an independent appraisal agency. The internal auditor should review and appraise not only the work of the department but also the working conditions of the personnel.

In speaking of the broad objectives of the internal auditor in performing special departmental audits, it has been said:

The objectives of the internal auditor in all of these special departmental audits is to verify the accuracy of the particular data there developed and to evaluate the efficiency of the processes carried on - both internally and as they have involved relations with other departments. He seeks to determine whether the particular activity is being carried on in a manner most conducive to company interests as a whole and at the lowest possible cost. (1)

Since management is often separated from all contact with the detail work of a department, the internal auditor should view the work of the department from the viewpoint of the company as a whole. The various phases of the work involved should be studied and the best methods and practices for the various routines should be considered. The internal auditor should determine whether the opportunities of specialization have been fully realized in each individual's case. The internal auditor's review should

(1). Victor Z. Brink, Internal Auditing, (New York: The Ronald Press Company, 1941), pp. 380-381.

include an appraisal of the degree of co-ordination of the work of one department with the organization as a whole.

Since the major portion of departmental operations are controlled by higher authority through the medium of written policies and procedures, the internal auditor's work involves acquainting management with the functioning of the policies and procedures at the departmental level. He should inform management as to what extent compliance is being made to the established policies and procedures.

The function of internal auditing in aiding management by appraising and reviewing the operations of the various controls can do a great deal in assuring the efficient operations of the business. The individual control placed over each separate function must be considered in the light of over-all operations. The internal auditing staff whose basic function is constructive appraisal and whose scope of operations is company-wide is the logical agency to maintain a constant watch on the operations of all of the managerial controls.

CHAPTER VIII

INTERNAL AUDITOR AND SYSTEMS INSTALLATION

There is some disagreement on the thinking of the responsibility of the internal auditing function in the field of installation of accounting systems. The differences of opinion arise as to whether the internal auditing department should be in charge of shaping operations which they will later be called on to appraise.

One school of thought argues that since the internal auditor comes into contact with all departments of the organization and reviews the records of all operations, he should be an expert on accounting methods and systems. They argue that the critical attitude of the auditor should ideally suit him for constructive thinking along the best lines of gathering and recording accounting data.

The opposing school of thought argues that the internal auditor engaging in systems work would be reluctant to install a detailed system; the adequacy of which they must later appraise. It is argued that in the event of failure of the system, the auditor is placed in both the position of the accuser and of the accused.

The argument is also brought forward that a special person or group should be responsible for the installation of systems. It is said that since this responsibility has not definite assignment in some companies,

it should be given to the internal auditing department, even though it may not be compatible with the other functions of internal auditing.

Since the work of the internal auditing department is often planned for long periods ahead, the time element is brought into the argument. The backers of the theory that installation work is not a function of internal auditing, state that to engage, for even the shortest period of time, in systems work would throw all of the future audits off of schedule.

In writing of the effect of additional work on the internal auditing department's co-ordination with the outside auditor, one authority says:

To co-ordinate properly there (the outside auditor) work with that of the internal auditor requires that both groups begin and end each section of the audit about the same time. It is contended that to add to the duties of the internal auditor any type of systems investigation makes a co-ordinated audit impractical, that schedules cannot be maintained, and that the value of the co-ordinated effort would be minimized if not lost. (1)

The weight of opinion and practice seems to back the principle that the internal auditor should not be given the line authority for the installation of accounting systems.

- (1). Philips C. Salman, "The Internal Auditor's Responsibility for Systems and Procedures, The Internal Auditor, (December, 1949), pp. 30-31.

In a survey made of 163 internal auditing departments of companies situated throughout the United States, the question was asked as to what responsibility the internal auditing department had in regards to accounting systems. The question was phrased so that the responsibility was broken down into the following three categories: whether the internal auditing department originated accounting routines, whether it reviewed them prior to adoption, or whether it checked and appraised the functioning of the routines once they were installed. The answers to the question were grouped as shown in Table 4. In regards to the findings, the following remarks were made:

From this summary as well as from individual replies, it is evident that many auditing organizations perform two or even three of these functions; but it is apparent that in the majority of cases the auditing department does not originate routines and procedures. It's principal connection with such operations is checking and appraising the functioning of authorized procedures. (1)

Table 4

Results of Survey Made
in 163 Internal Auditing Departments

<u>Extent of Responsibility</u>	<u>Number</u>
Originated Routines	62
Reviewed and Approved Routines Prior to Adoption	77
Checked and Appraised the Functioning of Authorized Routines	147
Total	<u>186</u>

- (1). G.T. Bodman, "Report of Industrial Committee",
The Internal Auditor, (June, 1945), pp. 59-60.

*G. T. Bodman, Report of Industrial Committee,
The Internal Auditor, (June, 1945), pp.59-60.

While the majority opinion holds that systems and routine origination and installation should not be a responsibility of the internal auditing function, the internal auditor should have a good background in systems work. In order to properly carry on the appraisal function, the internal auditor should have a thorough background in methods engineering, in systems, in procedures, and in other management control techniques. He should also know some of the fundamentals of job analysis, work simplification, work measurement, form design and layout, and associated subject. Without this knowledge, the internal auditor would be greatly handicapped in carrying out his responsibility of keeping management informed of weaknesses in the existing accounting systems.

Improving Accounting Systems

While the internal auditor is not usually held responsible for the origination of systems, he does have the responsibility of appraising the existing accounting systems. Through his review of the accounting records, he should be able to detect certain defects and be able to ascertain the needs for improving the routines by which the accounting data is cumulated.

The appraisal of the accounting systems is made up of two basic procedures. The first is auditing with

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Improving Accounting Systems

While the internal auditor is not usually held responsible for the origination of systems, he does have the responsibility of operating the existing accounting systems. Through his review of the accounting records, he should be able to detect certain defects and make suggestions for improving the routine by which the accounting data is maintained. The approval of the accounting records is one of two basic procedures. The first is auditing with

the objective of determining the degree of compliance with existing accounting instructions. If management is to realize the full usefulness of the accounting data, the data must be developed along the lines of consistent and uniform instructions. The second procedure has to do with the forms and methods which make up the accounting system. The internal auditor should assume a definite constructive viewpoint in order to determine what features or elements of the system present possibilities for improvement, thus furthering the aim of maintaining the accounting systems at a point of maximum efficiency. The internal auditor should report all opportunities for improving the existing system to the division of management most directly concerned with the matter.

Implements of Management as a Basis of Appraisal

The internal auditor has certain implements of management at his disposal upon which he can base his appraisal. Thurston lists five of these aids as follows:

1. Layout charts, against which to verify the maintenance of office and ship equipment.
2. Forms manuals, against which to check the forms in use.
3. Methods, procedures, or standard practice manuals, against which to substantiate that methods and procedures are being followed as presented.
4. Organization structure charts, against which to verify that positions are established as provided therein and that each person is carrying out the activity assigned.

5. Policy manuals, against which to check the policies being followed by the department or unit under audit. (1)

The aids or tools of management heretofore mentioned should act as guide posts in the internal auditor's consideration of the actual or potential contribution that each portion of the accounting system makes toward providing management with operating information.

In appraising the individual departmental systems, the internal auditor should keep in mind the place the department plays in the over-all picture of operations. The departmental records merely record one segment of the entire picture desired by management.

In speaking of the internal auditor's need for a broad viewpoint in the consideration of the effectiveness of a portion of the accounting system, it has been observed:

The Accounting System is at the same time more than the sum of its individual parts in the sense that the efficiency of it depends on the manner in which the parts are coordinated and combines to produce the final results. Here similar problems arise as to whether modifications in these relationships may result in greater accuracy, less delay, or better presentation of data, and whether these relationships can be developed in a more economical manner. (2)

- (1). John B. Thurston, "Improving Accounting Systems Through Internal Audits", The Internal Auditor, (March, 1948), pp.
- (2). Victor Z. Brink, Internal Auditing, (New York: The Ronald Press Company, 1941) p. 337.

One of the elements which plays an important part in the attainment of an efficient accounting system is internal control. As was pointed out in a previous chapter, adequate internal control calls for a definite division of labor and a possible overlapping of work in order to provide the desired checks. Since the training and background of systems and procedure experts tend to emphasize the elements of efficiency and economy, they may be weak when it comes to internal control. The internal auditor in his appraisal of the accounting systems should recognize that a need may exist for installation of certain additional steps in order to tighten the internal control. A proper balance between the benefits and the cost involved must be maintained.

The internal auditor should also appraise the accounting system from the viewpoint of the data produced. This appraisal would be based in part on the shortcomings of the system as shown in the number of errors made in the recording and the compiling of the data. This appraisal should be extended to considering the various methods of eliminating the causes of the errors.

The function of determining the accuracy of the accounting data is a basic responsibility of the internal auditor. It was to answer a need for a review of the accounting data that internal auditing was first initiated. While machine accounting has advanced the accounting process from a purely manual operation to a mechanical operation,

the element of error continues to exist as it does in all human endeavor.

The nature of the errors found by the internal auditor may be classed as those of a clerical nature and those of principle. Those of a clerical nature may result from lack or carelessness of the personnel. Those of principle may result from the lack of understanding of the accounting operations or faulty methods of conveying management policies and desires to the accounting personnel. The errors may be related directly to the accounts or to the methods and routines used in gathering the basic information. These errors may have resulted from defects in the original documents, the forms used, the equipment available, the personnel factor, co-ordination between departments, or many other causes. In any case, the internal auditor should make a determined effort to locate the defect and notify management so that the necessary action may be taken to correct the weakness.

The discovery of fraud of any type will immediately tell the internal auditor that a basic weakness exists in the accounting system. The internal auditor should make a study of the case histories of defalcations. He should consider the manner in which the frauds were committed in the light of the protection against such frauds given by the system of internal controls used in his company.

In connection with internal control as a

protection against fraud, the internal auditor should recognize that it is not possible to perfect internal control to the point where it is absolutely fraud proof. Thus, the internal auditor is improving the accounting system through audit programs designed to establish control over transactions in cases where it is either impractical or too expensive to work the usual checks and controls into the system.

In appraising the effectiveness of an accounting system, the internal auditor should determine whether the data gathered and the control maintained are worth the time and the cost involved. The cost should be a definite consideration in the review of all accounting systems. Often, the cost factor is over-looked and data is accumulated to a greater degree of accuracy than is needed by management. The internal auditor with his accounting background and his reporting responsibility to management is in a position to co-ordinate the accounting work with management's needs.

The internal auditor should investigate the length of time required to assemble the final reports for management's use. This review should not only be made to determine the cost of assembling the final reports but also to determine when management has the greatest need for the report. The value of the reports usually vary in direct proportion to the length of time separating the transactions from the time the data is placed in the hands of the interested parties.

Thurston, writing of the need for promptness in the preparation of reports says that the internal auditor should ask himself:

Is promptness sacrificed for accuracy in unimportant details or for figures which, from a management standpoint would be equally satisfactory if estimated approximately? Can unnecessary steps in preparation of statement and reports be eliminated? Is the personnel responsible adequate, both qualitatively and quantitatively? Can unnecessary steps in the preparation of statements and reports be eliminated? (1)

The explanation for undue lapse of time in preparation of the reports may be due to such factors as the lack of ability of the accounting personnel, inadequacy of the facilities with which they operate, or the manner in which the work they receive is channeled to them.

Another element which the internal auditor should investigate in his appraisal of the accounting is whether information of any kind is being accumulated when it is not needed or is not used. In direct relation with the above investigation, the internal auditor should determine whether all the information needed by management is being accumulated by the accounting records and whether it is being accumulated in its most useful form.

The above considerations go directly to the heart

- (1). John B. Thurston, "The Responsibility of Internal Auditing for Improving Accounting Reports to Management", The Internal Auditor, (June, 1948), p. 24.

of the accounting function. Records are kept only for management to use as a control over the operations of the business. If sufficient records are not being maintained to answer management's requirements, the system is not fulfilling its function in the organization. If needless information is being gathered, an unnecessary expense is being incurred and again the system is in fault.

The previous considerations of the internal auditor's role in the improvement of the system of recording operating data have been made from the viewpoint of appraising the system after it has been installed. However, the ideal situation would be to discover the defects before the system was placed in operation. While the internal auditor should not have the responsibility for originating the system, he should have the responsibility of critically reviewing the accounting systems or proposed changes in the existing system before they are placed in operation. A review by the internal auditing group with the aim of correcting all defects in a system before it is installed will save management the time, worry and expense of trying to change a system after it has been placed in operation.

The internal auditing function as an extension of the "eyes" of management has the responsibility of reviewing the workings of the accounting system as a part of every unit. The internal auditor should recognize breakdowns in the systems which prevent it from being of the greatest use

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The internal auditing function as an extension of the "eyes" of management has the responsibility of reviewing the workings of the accounting system as a part of every unit. The internal auditor should recognize beforehand in the systems which prevent it from being of the greatest use

to management. The defects uncovered should be promptly reported to management along with constructive recommendations for their correction. Through thoroughly performing its duties of appraisal, the internal auditor assures management that the data on which it bases its decisions are accurate and complete, and that it has been gathered at the lowest possible cost.

to management. The details uncovered should be promptly reported to management along with the corrective recommendations for their correction. Through thorough performance appraisal, the internal auditor assures management that the data on which its decisions are based are accurate and complete, and that it has been gathered at the lowest possible cost.

The internal auditor's primary responsibility is to the organization as a whole, and not to any one individual or department. He must be able to report to management the results of his work in a clear, concise, and objective manner. He must also be able to explain the reasons for his findings and recommendations. He must be able to work with management to develop and implement corrective action plans. He must be able to maintain the confidence of management and the public. He must be able to handle the most difficult and delicate situations with tact and discretion. He must be able to keep up to date on the latest developments in auditing and accounting. He must be able to communicate effectively with all levels of the organization. He must be able to work under pressure and meet deadlines. He must be able to handle criticism and defend his work. He must be able to maintain the highest standards of integrity and ethics. He must be able to handle the most difficult and delicate situations with tact and discretion. He must be able to keep up to date on the latest developments in auditing and accounting. He must be able to communicate effectively with all levels of the organization. He must be able to work under pressure and meet deadlines. He must be able to handle criticism and defend his work. He must be able to maintain the highest standards of integrity and ethics.

CHAPTER IX

THE REPORT

The internal auditor's work of appraising the various operations of the organization is not completed until the results of the appraisal have been communicated to management. The auditor's report constitutes the major means of conveying the information concerning his activities to management.

Auditing information can be compared with accounting information in that the efficiency with which it achieves its objectives depends directly on the type and the extent of the reporting. If management does not receive a report of the findings of the internal auditing group, it does not have a basis for control over the internal auditing activities. The productiveness of the internal auditing department can be best judged by a review of the reports of the audits performed.

The reports of the internal auditor should not be designed or treated as accounting reports. The reports issued by the internal auditing group contains information as to the efficiency of the various departments and units reviewed and often contains recommendations for the correction of the defects uncovered. The accounting reports contain data, the interpretation of which leads to control over financial and operational functions. Thus, the difference

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in content requires a different approach by management in the use of these two reports.

The report of the internal auditor should not follow the form of reports issued by the outside auditor. The latter reports are designed to serve definite professional, regulatory and legal purposes. As a result, the report issued by the outside auditor is fairly rigid in form. The internal auditor's report is written only for the use of management, thus the wording and the content of the report is direct at conveying the information that will aid management in controlling the function being audited.

In a survey made by the Industries Committee of the Institute of Internal Auditors of 171 companies, it was found that 94% of the companies required written reports as the internal auditor's method of communicating the findings of its audits to management. (1)

Naturally the form and the content of the report will vary with the type of audit or review performed by the internal auditing group. The reports may be broken down under four major groupings. These are:

1. Report on Regular Periodic Audits
2. Report on Special Audits
3. Report on Subjects Requiring Immediate Attention
4. Confidential Reports on Personnel.

(1). Report of the Industrial Committee", The Internal Auditor, (June, 1945), p. 60.

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In a survey made by the Industrial Committee of the Institute of Internal Auditors of IIA members, it was found that 84% of the companies required written reports as the Internal Auditor's method of communicating the findings of its audits to management. (1)

Actually, the form and the content of the report will vary with the type of audit or review performed by the Internal Auditing group. The reports may be broken down under four major groupings. These are:

1. Report on Regular Periodic Audits
2. Report on Special Audits
3. Report on Subjects Requiring Immediate Attention
4. Confidential Reports on Personnel

(1) Report of the Industrial Committee, The Internal Auditor, June, 1945, p. 60.

As was pointed out, the greater majority of the reports made by the internal auditing group are written reports. The reports classed in category three and four could be handled in some cases by an oral report. However, in order to have a permanent record not only for the guidance of subsequent audits, but also from which to judge the progress toward perfection in operation and management, written reports should be the standard means of communication of the internal auditing group.

Reasons for Written Reports

The written report is fundamental to the operations of an active internal auditing department. The value of the written report lies in the fact that it establishes a clear cut means of communication with all parties involved in the auditing function.

Also the report can be utilized at the most opportune time if the findings are in writing. Management is presented with all of the necessary information available and can digest this information at the time when it is most convenient. Moreover, the same information can be furnished to the department heads or supervisors of the various activities audited with little or no extra effort.

The written report sets down those matters which involve significant departures from the established policies and procedures. It presents the conclusions and the recommendations of the internal auditing group relative to

constructive changes in the activity reviewed. The written report thus lays the ground work for the ultimate objective of internal auditing--the promoting of management action which will aid in more efficient operations of the various functions of the organization.

The written report is of further general value to management, in that it gives a review of the data relative to the current financial and operational functions of the company. The reports may contain financial statements, analytical schedules, comments on unusual phases of operations and data relative to the company's efficiency and progress. Such information can be used by all executives regardless of whether or not they are directly responsible for the unit that was audited. The written report provides a convenient medium for a review or discussion of important phases of departmental operations at any time.

The written report also furnishes a permanent record of the work done by the internal auditing group. Since an audit may often be a one man operation, with little or no direct supervision, the report gives a control over the individual activities of the internal auditing group. In speaking of this function of the written report, Thurston says:

Internal audit reports and the work papers behind them provide the permanent record of the work performed by the internal auditing department and the results it has accomplished. Many occasions arise where it is of major importance to have proof that certain matters or situations were

recognized and that action was taken to correct them. Properly indexed and summarized, written internal audit reports constitute an important record of the progress of departments, divisions, and subsidiaries and of the business as a whole. (1)

It should be recognized that one report is not a complete picture of a department or division of the company, rather it is a chapter in the history of the division or unit that was audited. Therefore, before every audit, the internal auditor should acquaint himself with the prior history of the unit he is to audit. In this way, he is able to obtain certain basic information that will enable him to have a firm foundation for the audit he is to perform. He should determine how the department or division has been operated in the past and what conditions were previously pointed out as requiring attention. The internal auditor should determine whether the failures and defects disclosed in previous reports have been corrected, or, if not, whether some acceptable reasons exist for their continuance. The written report thus sets down in a documentary fashion the disclosures of the internal auditing group and establishes a basis for later references to the accomplishment of the audit activity. It is often extremely important that proof be available that certain matters were properly recognized at an earlier time by the internal auditing group.

- (1) John B. Thurston, Basic Internal Auditing and Techniques, (Scranton, Pennsylvania: International Textbook Co., 1949, pp.68-69.

The close cooperation that is built up between the internal auditor and the outside auditor is fostered through the use of written reports. To facilitate the work of the outside auditor, the internal auditor should keep him informed of all auditing activities performed by the internal auditing department. It is highly advisable to promote this flow of information by forwarding to the outside auditor copies of all the reports that relate to the work performed by the outside auditor. If he is satisfied with the procedures followed by the internal auditing department, he may make only test checks on certain phases of his audit. As a result, the outside auditor is able to spend more time on those operations which he considers are in need of closer reviewing. If the outside auditor receives the reports of the internal auditing department at the conclusion of each audit, he is in a position to investigate immediately situations he may be interested in instead of postponing such action to the time of his regular audit. Such reports also help keep the outside auditor up-to-date with the progress of the business between his audits, and as a result he does not lose time in reviewing past operations before commencing his auditing work. In cases where written reports are not used, or if copies of the written reports are not sent to the outside auditor, the internal auditing department should make an effort to inform the outside auditor, either orally or by letter, about all unusual findings that may concern him.

Type of Written Reports

The written reports may be classified into three different categories: letter, questionnaire and essay type reports. Each type of report has a special use in communicating the finds of the internal auditing department to management. The type of report selected should be governed by the consideration of which one will best convey the information to management in the clearest and most efficient form.

The letter type of report finds its greatest use as a supplement to the carrying out of the regular auditing activities. One of these uses is of an administrative nature when it is used by an internal auditor who is working in outlying plants as a means of reporting certain conditions and who seeks further guidance from his superiors. Again, it may be used to call the special attention of a department head to a procedure or policy of which he may have been ignorant. It may be used to confirm a fact which has not been fully substantiated by the internal auditor in his working papers. It is felt, however, that this system of reporting has definite limitations when it is the only type of report used. It represents an incomplete means of conveying the desired information in that it is usually limited in length and as a result may be confined to a few highlights of the audit. Furthermore, the presentation is informal and includes none of the financial statements or schedules which are often invaluable in conveying detail

data in the essay type of report.

The questionnaire type of report consists of placing the findings of the audit in spaces provided for on a printed form carrying a list of specific questions. One advantage of the questionnaire type of report is that it provides a uniform type of report from all auditors performing the same type of audit. This type of report also provides a definite control over the auditing methods used. Since the questions are specifically stated, the auditing work is directed at predetermined objectives.

The great danger in the use of the questionnaire type of report is that the auditing function tends to become stereotyped with little or no new investigation procedures introduced by the internal auditor. The answering of predetermined questions are likely to become mechanical in nature, resulting in a deficiency of constructive analysis and comment. Moreover, there are certain complex matters, that the auditing function should cover, which cannot be reduced to simple questions and answers. Since these matters often call for detailed explanation, the questionnaire type of report may be inadequate in the extent of information furnished. The questionnaire type of report finds its greatest usefulness in auditing only the simpler situations where the auditing is very routine in nature. It can also be used as a check list or a supplemental schedule to an essay type report.

The last type of written report, the essay type, is the most frequently used for presenting the results of an

audit to management. This type of report answers the needs in furnishing an over-all media for reporting all types of auditing activities. In discussing the essay type of report and its relations to the reporting responsibility of the internal auditor, Brink lists the desired characteristics of the report as follows:

1. Short and concise letters of transmittal or introductory summaries should be used to indicate the findings of special importance.
2. The report should be broken up with suitable headings to make possible greater ease of reading and to permit the several executives to select the matters in which they are primarily interested.
3. Major emphasis should be placed on findings as to matters of special interest to management. These would include such matters as defective situations of major importance and conclusions or recommendations as to new procedures or policies which are of real significance.
4. The detail of routine and minor findings should not be given. If these matters are touched upon at all, only general summary statements should be made.
5. Voluminous schedules or analysis should be avoided where possible. In the event they are needed necessary, such schedules should be placed in the appendix and discussed in summary form in the main body of the report.
6. The report should not be crowded full of details concerning routine audit procedures carried out. A general statement on the scope of the audit is normally sufficient especially when the audit is based on company manual of auditing procedures. (1)

(1) Victor Z. Brink, Managerial Control Through Internal Auditing, (Stamford, Connecticut: Brock and Wallston, 1943), p. 69

The aforementioned six characteristics are all aimed at the objective of presenting the findings of the internal auditing department to management in a way that it will be of the greatest use.

The points emphasized depend to a great degree on the parties who are to make the greatest use of the report. The various detailed auditing operations are sometimes cited at great length when the party to whom the report is directed is interested primarily in the control exercised over the operations and desires to know the methods by which this control was appraised. Often in reports which are also used by the outside auditor, the reporting of the auditing procedures used is desirable. In a report of this type it may also be desired to make a detailed explanation of all exceptions found and an account of adjustments made to correct these exceptions.

If the internal auditing department has a standardized procedure of verification and a written set of audit procedures, the detail of the methods used in the audit may be omitted. If the procedures have been reviewed by the outside auditor before being put into practice, the outside auditor is only interested where auditing methods other than the standard ones were used and he so notified. On the whole,

management is seldom interested in the detailed methods of performing the audit.

Some reports may place emphasis on the presentation of financial data. The financial data should be emphasized only where the audit is aimed at some particular financial operations, and the report is directed to an officer directly interested in the financial control of the organization. The accounting records rendered through the regular accounting system usually answers management's need for financial data. However, in some cases the internal auditor may make certain analysis if the financial data gathered by the accounting system. In such cases the presentation of financial data is the sole objective of the report. Care must be taken in the presentation of such data so that the results will not be a bulky document which cannot be effectively and conveniently used by management.

Since the central theme of the internal auditing function is the appraisal of operations, the usual auditing report should place emphasis on unusual or defective situations that were found. The report should provide management with all the information needed for effective control of operations without burdening the executive with mountains of detail. The acid proof test is whether the comments and schedules in the report are of use to management and whether they will produce maximum results with minimum effort. The report should be a basis for management in its appraisal of

of organizational responsibility, in forming its decisions on special actions or in its modification of current policies and procedures.

Release of Reports

Extreme care must be taken to see that items reported are accurate before the report is released. The internal audit report represents a formal means of reporting to a higher authority; thus, the quality of the internal auditor's work is judged by the accuracy of the reports he renders. One of the surest ways of ascertaining the accuracy of the report and at the same time obtaining the viewpoint of the operating personnel is to discuss the report with the head of the department or unit audited. The internal auditor in the course of his work may have arrived at a mistaken or semi-erroneous conclusion from the facts he reviewed. The head of the department or unit audited may be able to point out certain circumstances which would make portions of the report inaccurate or misleading. The correction or modifications of such portions will avoid later embarrassment for the internal auditor and at the same time present management with a more accurate picture of the situation. Moreover, the procedure of discussing the findings of the report with the local officers responsible for the department that was audited represents a gesture of teamwork and cooperation which will tend to promote a closer spirit between the operating and the auditing personnel.

It will enable both parties to get a better insight into the work and the problems of the other. A free exchange of viewpoints in regards to the findings of the internal auditor should result in more efficient internal auditing.

In every report there are certain matters which more or less are in the category of a confidential nature. Such matters as may be related to attitudes, compensation or efficiency of the local officers could hardly be discussed with these officers until the report was presented to those officials of management desiring the information. Such reports are by far in the minority, thus the greater percentage of the reports can be discussed with the officials responsible for the unit auded before the report is presented to higher management.

In an organization where the internal auditing function operates over a wide geographical area, the central internal auditing office should be the point of release for all reports. The most satisfactory procedure found for the preparation of reports is for the internal auditor who performed the audit to write the report at the time the audit is made. In this way certain points that arise in the course of writing the report may be answered at first hand. The auditor should then send the report along with the file of working papers to the central internal auditing office. The central office will review the report and check it against the working papers as is deemed necessary. Often the audit-

or performing the audit is so close to the work that he may take certain facts for granted. The central office in its review of the report can detect and correct statements which may be misleading or ambiguous. In reviewing the report, questions may arise which call for further explanation. In such cases, the auditor who performed the audit should be personally consulted if he is available. Once the report has been thoroughly reviewed and is ready for formal release, it should be released over the chief auditor's signature as the representative of the internal auditing department.

Follow-Up

If the defects and errors disclosed by the internal auditor in the report are not corrected, the entire time and energy spent on performing the audit are wasted. In writing of the necessity for action based on the findings of the report, Brink says:

The final realization of internal auditing objectives is accomplished through the realization of the audit findings in applying the needed action. To a major extent this is in the hands of management once the matters have been reported to the executive group by the internal auditing department. While the internal auditing group cannot force management to take action along a particular line, it can, however, contribute to the more efficient utilization of the audit data in several ways. (1)

- (1). Victor Z. Brink, Internal Auditing, (New York: The Ronald Press Company, 1941), pp. 421-422.

The chief auditor as head of the internal auditing department can be a powerful force in the organization and can do much to induce action relative to the findings reported. He has the opportunity to clarify report data, and as the focal point of all audit findings he has a background which enables him to supplement the report with additional information. By maintaining constant contact with the various activities of the company, he is in a position to determine whether particular matters reported are being actively followed through. In cases where he knows that findings of the audits have been sidetracked or delayed in presentation to the parties concerned, his constant contact with the executive group places him in a position to advance the presentation by calling the matter to the attention of management. Thus, while the chief auditor is not a part of line management, he can aid management by keeping constantly before them matters that need their attention.

A second way in which the internal auditing group can aid in furthering efficient operations is through a re-examination of defects uncovered in previous audits. Before starting on an audit, the auditor in charge should review the previous audit reports regarding the unit he is to audit. He should determine what action had been taken in regards to the recommendations made in the audit report. If no action has been taken he should review the matter. If a change in method is needed or a defect still exists, he should again make the recommendation a part of his report and state that

no action had been taken on a previous recommendation.

In speaking of the need for reviewing previous audit reports, it has been said:

If each internal auditor thus reviews the preceeding report, all unfinished business will automatically be carried forward and each year be emphasized without the necessity of the new auditor referring to all previous reports. Many matters with which the internal auditor has to deal cannot be changed in a complete manner within single audit periods. The program of constructive modification must often be gradual and worked over a considerable period of time. (1)

Submitting The Report

The report should be submitted to the appropriate major executive as soon as possible. It is important that the report be prepared promptly by the internal auditor since any delay in writing the report will tend to weaken the memory of the auditor in regards to the findings of the report and may have an adverse effect on the quality of the report. From the viewpoint of the activity which was audited, promptness in presenting the audit report will give greater effectiveness to the report. Delay in making known the results of the audit to the departmental head concerned will lessen his interest in the findings and will permit conditions which need to be corrected to continue for a longer period of time.

A problem sometimes arises in the control of the work of the internal auditing group. As an aid to controlling the auditing activities the chief auditor should state

(1). Victor Z. Brink, Internal Auditing, (New York: The Ronald Press Company, 1941), p. 422.

the period covered and perhaps attach a note to the report going to the executive to whom he reports, giving the number of man-hours involved in performing the audit.

As a further aid to this control, Nicholson makes the following suggestion:

I hold that the auditor should be required to prepare a schedule near the end of each year which sets forth the title of the audit and the number of man-hours to be consumed during each examination for the coming year. Furthermore, I believe a column should be provided which indicated the time spent on the last similar audit to enable management to ask questions concerning increase or decrease in auditing hours. (1)

In regards to the above suggestion, Nicholson says that he does not believe that the chief auditor should disclose to anyone, including his superior, the date on which the audit will be performed.

In submitting the report, great care should be taken in preparing every portion of the report. The manner in which a report is written and the form in which it is submitted will have a great bearing on the effect it will have in stirring up approximate action. The report is often the only contact that many executives have with the internal auditing department, and as a result they judge the work of the department strictly on the reports which are submitted to them.

(1). Frank B. Nicholson, Report Writing, Internal Auditing Looks Ahead, (New York: The Institute of Internal Auditors, 1949), pp. 17-18.

CHAPTER X

THE INTERNAL AUDITOR AND THE OUTSIDE AUDITOR

Need By Outside Auditor For Additional Aid

The past fifteen years have seen vast changes in the responsibilities of both the internal auditor and the outside auditor or public accountant. The outside auditor's field has been enlarged through the addition of new responsibilities. These new responsibilities have forced the outside auditor to seek new techniques and methods to verify the accuracy of the statements he is called upon to certify. As a result of this increased responsibility the outside auditor has turned to the internal auditor for aid.

In summing up the need for close cooperation between the internal and the outside auditor, Bring observes:

Since the outside auditor cannot make a detailed audit of all company transactions he must rely to a considerable extent on the adequacy of the company's internal procedures. A substantial part of his examination is, in fact, concerned with testing of the company's system of internal control. Because of this dependence on internal control, the outside auditor is definitely interested in the internal auditing program. (1)

The increase in the size of the average corporation has brought about changes in the relationship between the corporate organization and the outside auditor. The relationship

(1) Victor A. Brink, Managerial Control Through Internal Auditing, (Stamford, Connecticut: Brock and Wallston, 1943), p.85

has changed from an intimate one where the outside auditor has a firm knowledge of most of the transactions to one where he is able to verify only the figures that have a direct bearing on the published financial statements. In the past the outside auditor often had a major role in the development of the routines by which the accounting data was gathered. He was therefore much closer to the source of the data and could certify the financial statements with considerable confidence.

The introduction of specialized accounting officers, the increase in the number of accounting transactions and the geographical expansion of operations have all worked to separate the outside auditor from the basic detail data of operations. The complexity of the company's operations have led to the development of specialized procedures and routines which are increasingly difficult for the outside auditor to handle in the comparatively short time allotted for his work. In writing of the increased need for specialized knowledge in auditing technical operations, Brink states:

Certain auditing operations of the outside auditor are made exceedingly difficult by his lack of special knowledge concerning the products and physical operations of each company. This is true, for example, in the examination of inventories, or, as another example, fixed assets. (1)

(1). Victor Z. Brink, Managerial Control Through Internal Auditing, (Stamford, Connecticut: Brock and Wallston, 1943), p. 89.

The internal auditor through his daily contacts with operations and operating personnel should have a technical background which will aid the outside auditor in his work. Through either working with the outside auditor or else always being available to explain certain details, the internal auditor can save the outside auditor a great deal of time and trouble.

The modern corporation is financed by the thousands of individuals who have no part in the management of corporate affairs. The stockholders depend on the published financial statement for an accounting of the way management is operating the business. The reliability of the published statements must be vouched for by a competent, disinterested outside party. It is in the role of a disinterested reviewer of the operations of the company that the outside auditor assumes his greatest responsibility. With the increased difficulty of performing detailed audits, the outside auditor has been forced to rely more and more on the functioning of the internal controls of the organization for the accuracy of the data gathered by accounting routines, particularly as these controls are related to the data developed for the financial statements.

In the chapter on controls, it was pointed out that the internal auditor was responsible for making frequent checks on the operations of the controls and for reporting all cases where the controls have broken down. The dependence of the outside auditor on the proper functioning of

the internal controls has resulted in a close observance of the methods used by the internal auditing group in its function of auditing the various phases of the organization.

The outside auditor is further interested in the work of the internal auditing group because the internal auditing function is one of making an independent review and appraisal of company activity from within the organization. It is a group which carries on an activity and uses methods and techniques similar to those of the outside auditor. Thus while the objectives of the two auditing groups may not be the same, the findings of one group may often be used by the other in the course of their audits. The training and the background of these two groups should act as a supplement to each other in furnishing management with the information it desires.

The broad, general experience of the outside auditor in many phases of accounting and in various types of industries gives him a wealth of background that will be of aid to his client. The internal auditor, on the other hand, through his close association with the various phases of operations in a particular organization is thoroughly familiar with the technical details of operations. By working together the outside auditor can aid the internal auditor and at the same time receive important aid from the internal auditor.

While the work of the two auditing groups supplement

each other, their prime objectives are not the same. The outside auditor's work is directed to the certification of the company's financial statements, and every detail of his audit is consciously or unconsciously directed toward the carrying out of that responsibility. The internal auditor's prime objective is the review of internal operations for the benefit of management.

It should be recognized that the primary responsibility for the validity of the financial statements is not the outside auditor but management's responsibility. Management has realized this more in recent years. The outside auditor often uses written confirmations signed by an officer of the company, setting forth the officer's belief in the accuracy of the particular set of data and at the same time setting forth the conditions or practices which may have a bearing on the validity of the data. The practice of signing such data has increased the realization of the company officers to the fact that they have a definite basic responsibility for the accuracy of the financial data. The awareness to this responsibility has caused management to look for a verifying agency to operate from within the organization. It is in this role of a reviewing agency that the internal auditor has come into its important position as a verifying agency. It also provides an important illustration of the close relationship existing between the two auditing groups.

Coordination of Work

Coordination between the internal auditor and the outside auditor may be broken into two categories. This breakdown may be classed as coordination through independent audits and coordination through joint audits.

As was pointed out previously in this chapter, the work of the internal auditor and the work of the outside auditor is complementary. Since the two auditing groups are especially qualified to perform certain types of auditing, coordination is often achieved by having the outside auditor use the reports developed by the internal auditing group.

In order to be able to make use of the work done by the internal auditor, the outside auditor should have a predetermined program of what information he will use. The outside auditor should confer early in the year with the Chief Auditor in regard to this program. At this conference the audit program should be reviewed not only as to what departments and units will be audited, but also in the light of what auditing procedures and standards are to be followed. The outside auditor should determine whether the procedures are of sufficient scope, and if the results of the audit can be used to the fullest extent in eliminating certain phases of his work involving detailed auditing.

In writing of this type of coordination of auditing activities, Werntz states:

The internal auditor can, and is expected to undertake more exhaustive inquiries and is likely to have a better grasp of the technical matters involved in the company's operations than has the public accountant. Hence the internal auditor will usually be specifically qualified and adept in detailed investigations of particular features of the company's financial affairs.

(1)

Every effort should be made to develop a program that will eliminate duplication of effort, especially in detailed verification. The outside auditor as a specialist in his field and can often aid the internal auditor in setting up his audit program.

Management should encourage the internal auditor to seek the advice of the outside auditor on problems which may arise throughout the year. Management should instruct the outside auditor to work closely with the internal auditor and to recognize the internal auditor as management's representative in all matters relating to verification of financial matters.

The work done by the internal auditing group can and should be used to reduce the time spent by the outside auditor in performing the annual audit. Proper coordination between the two fields of auditing can be of real benefit to management in the form of reduced cost of certification, improvements in the system of internal control, and in

- (1). William M. Werntz, "Viewpoint of The Securities and Exchange Commission on Internal Auditing", Journal of Accountancy, (December, 1943), p. 476.

more dependable financial statements. The outside auditor will benefit in the sense that full coordination will permit him to render his most effective service at a minimum of cost.

In speaking of the cost advantage in coordinating the work of the internal auditor and the outside auditor, Brink states:

In as much as the cost of providing internal auditing effort is so much less than that of providing the services of the outside auditor, it is to be expected that internal auditing operations will be carried on in a much more detailed manner. The outside auditor, on the other hand, will confine his verification efforts to the matters of greatest importance and will utilize the test check device where the volume of detail is too great. (1)

Peloubet supports the theory that the internal auditing department can furnish detailed audit information at a lower cost.

Furthermore, it is generally true that in the detailed requirements of an internal audit staff, familiarity with one industry, and with the client's affairs in particular, probably make the work of the internal auditor more effective and more economical than that of the staff of a public accountant. The latter, however well trained generally it may be, must, as a natural result of being prepared to meet almost any situation at short notice, be less expert in a particular industry than a group of men who have spent some time in the employ of a client as internal auditors.(2)

- (1). Victor Z. Brink, Internal Auditing, (New York: The Ronald Press Company, 1941), p. 464.
- (2). Maurice E. Peloubet, Audit Working Papers, (New York: The American Institute Publishing Company, 1937), p. 23.

The chief auditor should provide the outside auditor with precise, comprehensive information as to what the internal auditing group has and has not accomplished in the substantiation of the corporate accounts. The outside auditor should be kept posted on the current activities of the internal auditing group through receipt of copies of the report of each audit. If the outside auditor is able to review the work of the internal auditor as the year progresses, he will be able to plan his annual audit with a fuller understanding of the problems of his client. He will be able to pick out the major exceptions brought to light by the internal auditor. The outside auditor should keep a list of these major exceptions and should make definite inquiries as to what action has been taken to correct them. In cases where he is not fully satisfied with the explanation, the outside auditor should make an independent review of the situation. If the outside auditor follows this type of action, management can be doubly sure that the findings presented by the internal auditor will be put to a beneficial use.

The contacts built up by the members of the internal audit department can be of great use to the outside auditor. The internal auditor is familiar with the organizational set-up, and can often direct the outside auditor to the right party for certain desired information. The internal auditor is familiar with the routines and procedures followed by the various units of the organization; thus he can

aid the outside auditor by explaining company methods and practices whenever the information is desired.

The personnel of the internal auditing department can often assist the outside auditor in the observation of the taking of inventories and in the physical testing of inventories. The technical aspects of many inventories prevent the outside auditor from being fully qualified to act as an appraiser of the materials. If the company does not have an internal auditing department which coordinates its work with the outside auditor, it would be necessary for the outside auditor to substantially extend the scope of his audit so as to assure himself of the reasonableness of the inventory figure. In writing of the various ways of coordinating the work of the internal auditor with the outside auditor, Brink states:

The internal auditor possesses, to some extent, that which the outside auditor lacks - a familiarity with technical aspects of the company's products. This special knowledge can be utilized effectively by the outside auditor either through a greater reliance that can be placed on the internal auditor's inventories, or through the direct use of internal auditors in assisting the outside auditor when the latter makes his own physical verifications. It would seem that a particularly useful and important basis of coordination is provided here, and one which will be utilized to an increasing extent in the future. (1)

- (1). Victor Z. Brink, Internal Auditing, (New York: The Ronald Press Company, 1941), p. 473.

The outside auditor cannot rely wholly upon the reports of the internal auditor. In order to justify his certification in his own mind, he must still do a certain amount of testing and sampling beyond that done by the internal auditors. However, if the internal audit reports reflect intensive and satisfactory examinations, and if experience justifies reliance upon the credibility of internal audit reports, the outside auditor may safely plan his own program with reasonable expectation that his own testing of detail will corroborate the findings of the internal auditor reports.

Joint Audits

The term "joint audit" refers to that type of audit in which the various phases of work are divided between the internal auditor and the outside auditor, and are carried out at substantially the same time. The work performed pertains directly to the outside auditor's function of certifying the published financial statements.

The joint audit is of comparatively recent origin. It was not until 1942 that joint audits achieved their full importance. This importance resulted from the continued need for accurate accounting while the man-power of the outside accountants were drastically cut by the demands of the armed force. As a result audits were planned whereby the internal auditing personnel would work closely with the outside

auditor in carrying out the annual audit program. As a result of these early efforts, management has become increasingly aware of the advantages of a well coordinated joint audit program. The joint audit is possible because the fundamental and primary responsibility for the accuracy of the financial statements rests with management and not entirely with the outside auditor who certifies the information as being fairly presented.

The basis of a joint audit is a well prepared, written program that will lead to a synchronization of effort. The extent to which such synchronization can be achieved is dependent upon the limitations to which the outside auditor is willing to confine his work and to pass work on to the internal auditor. The establishment of such limitations by the outside auditor is greatly dependent upon the organization of the company being audited, its procedures, and its system of internal control. The second factor in the establishment of such limitations is the size, the caliber and the status of independence of the internal auditing department.

The extent to which the outside auditor may delegate auditing responsibilities to the internal auditor is dependent on the judgement of the outside auditor. This dependence is commented on by Peloubet as follows:-

However, the distribution of responsibility between the independent and the internal auditor is by no means uniform or consistent in different organizations, and the extent of the reliance which the independent auditor may place on the

work of the internal audit staff is determined by its personnel and by the attitude of the management to its work. (1)

Management should be ever alert for means by which they can obtain greater effectiveness from the forces they have available. Through the joint effort of the two auditing groups working toward the same objective, management should be able to obtain more effective auditing results from the amount expended for the services of an outside auditor. Saxon lists the results that can be achieved by joint audits as follows:-

1. The public accountant has been provided with a factual review of the company's methods and procedures, which revealed any weaknesses in internal control and gives him the means of establishing the objective existence of the control factors.
2. The duplication of work involved in separate examinations has been eliminated. This has saved time and effort on the part of both staffs - internal and external.
3. Suggestions for simplification and improvement in company procedures have been more readily obtained and corrections more easily effected.
4. By a careful preplanning of the work, the audit man hours required have been cut substantially.

(1) Maurice E. Peloubet, Audit Working Papers, (New York: The American Institute Publishing Company), p. 27.

5. To close association with the public accountant has increased the quality of the work performed by the internal staff. (1)

Management should be ever alert for means of obtaining greater effectiveness from the forces they have available. Through the joint effort of the two auditing groups working toward the same objective, management should be able to obtain more effective auditing results.

Aid To Internal Auditor

A great deal has been said as to how the internal auditing group can be of service to the outside auditor through cooperation in performing the annual audit. However, this flow of service is two ways, and the outside auditor can exercise a tremendous influence on the internal auditing staff.

One of the greatest of these influences exercised by the outside auditor is in the fostering of internal auditing departments in their clients organization. The outside auditor has been among the first to recognize that changing conditions were making it virtually impossible for him to perform the detailed auditing required for a thorough review in the time allotted. They have been among the leaders in recommending that internal auditing staffs be established in order to achieve better internal control.

- (1). Carl F. Saxon, "A Case History of Joint Audits", Internal Auditing A New Management Technique, (Stamford, Connecticut: Brock and Wallston, 1943), p. 101.

The outside auditor is definitely interested in utilizing the services of the internal auditing staff once it has been established. In order to get full benefit of the work done, the outside auditor is interested in the extent and the manner in which the internal auditing program is carried out. The outside auditor being a specialist in his field can often give advice that will aid the operations of the internal auditing department. He possesses a wide and varied background which enables him to give aid on auditing problems thus increasing the internal auditor's professional knowledge and proficiency.

The outside auditor has further influenced and aided internal auditing by supplying the nucleus of the staff of many internal auditing departments. The outside auditor brings to the company a vast store of knowledge which will aid management in improving the company's own auditing procedures and practices. Moreover, the background of the outside auditor enables the company to adopt its auditing activities to more effectively satisfy the needs of the outside auditor.

In making recommendations to management for changes or improvements in the existing systems, the internal auditor must rely on management for effecting the recommendations. Sometimes these recommendations are overlooked or are not acted upon in a manner thought to be according to the best accounting practices. If the

recommendations have definite merit the outside auditor can assist the internal auditor by forcefully bringing these matters to management's attention. This assistance is important because the second recommendation by an outside third party will often get the desired results.

It can be seen that the internal auditor and the outside auditor both have a definite function to serve in the modern business organization. The objectives of their work are different, but the auditing procedures used are based on the same principles. Since these two groups follow the same procedures, they can be of great assistance to one another in attaining their desired objectives. The two auditing forces in coordinating their efforts make available to management a more complete and a more economical appraisal of the company's activities than could be achieved by either one working alone.

CHAPTER XI

CONCLUSION

Current Status Of Internal Auditing

The scope of the internal auditing function at present varies widely from business to business. The differences in the service rendered may result from either management's lack of realization of the full possibilities that can be derived from an internal auditing group, or else management realizes the possibilities but does not see fit to give the internal auditors the authority and the independence that is needed to function at full efficiency.

The preceding chapters have developed some of the functions of internal auditing in its relationship with management. These functions have been presented in broad general terms rather than in detail since the detail of the service rendered will vary according to the form of the organization and the type of operations.

It has been pointed out that a definite need exists for the services that the internal auditor can render to management. In a large number of cases where internal auditing departments have been established, management has not received the full benefit of the internal auditor's work. This lack of receiving a full return can be attributed to either management or the internal control. Management has continued to look upon the internal auditor as

part of the system of verifying the accounting records. This narrow viewpoint has in part been caused by the concepts and qualifications of the internal auditor. The majority of the internal auditors have a firm background in accounting and have the accountant's viewpoint in performing their work. In order to broaden their services to management, the internal auditor must have a good understanding of management's problems. To achieve this understanding the internal auditor should balance his accounting background with a firm grounding in subjects relating to the science of business management. Possibly if the name "Auditor" was not given to the internal auditor, a better understanding would be had of the wider scope of his work. The term "Auditor" carries with it the stigma that the work done is purely in the review of the accounting data.

The question may be raised as to why the internal auditor should attempt to expand his activities. Is he trying to enter into fields of operations where he does not belong? On the contrary, a definite need exists to keep management informed as to the progress of all operations. The accounting data, which the internal auditor reviews, stems from all of the functions of the business. The internal auditor is a reviewing agency for this accounting data thus it is only natural that it expands its activities into those fields which are only indirectly concerned with accounting. As a result of the increased complexity of operations, management has turned to internal auditing as the logical

answer to many of its control problems.

Future Prospects For Internal Auditing

Over the long run a function or a department of a business organization will develop in a manner which is justified by its ability to satisfy certain business needs. The extent of this development will depend on both the recognition of the need by management and the qualifications of the men who work out the techniques to satisfy the need.

The increased understanding of internal auditing by management will lead to the improvement of the department's status in the organization and will be the major factor in fostering the continued rapid growth of internal auditing. The better understanding of internal auditing will also lead to the employment of more capable personnel, and the general development of greater cooperation with their work.

One of the fields in which internal auditing will have a great expansion of its service is in the development of a more effective kind of cooperation between the internal auditor and the outside auditor. This coordination is particularly desirable in that by being relieved of a greater amount of detailed verification, the outside auditor will be able to direct his energies into channels for which he is especially qualified.

The field of internal auditing has vast potentialities for service to management. Many organizations have

only scratched the surface of the services that they can gain from internal auditing. As time goes on these possible services will be recognized and internal auditing will continue to grow to meet the increased demands placed upon it.

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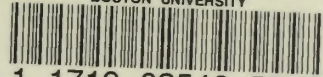
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